

# DOES DEMOCRATIC TRANSITION SPUR FINANCIAL DEVELOPMENT

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## Abstract

This paper examines whether democratic transition promotes financial development using a panel dataset of a maximum of 48 events of democratic transition. In this paper, we offer a first assessment of the results on probably the most important political change, namely transition from an autocratic regime to a democratic one. We include in our estimations control variables as well as the duration of the democratic experience. The preliminary evidence by a “before-and-after” approach indicates that in general democratic transitions are followed by a long-run boost in financial development.

The results indicate that on the short term, democratic transition seems to stimulate the importance of the financial services performed by commercial banks, their ability to mobilize funds to finance entrepreneurs as well as the general level of financial sector development; whereas it tends to produce no immediate effect on the quantity of funds that is channeled through the banking system to the private sector. However, on the long run, the move to a democratic system has a positive effect all over the different aspects of financial development, as a democratic political process dilutes the degree of elite control over economic resources.

***Keywords: political institutions, democratic transition, banking sector development, stock market development***

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## 1. INTRODUCTION

Recently, many Arab countries have entered into a process of democratization and other started a program of deep political reforms. This raises the question of the economic and financial impact of such political changes. Besides, the debate on democracy and development has recently received greater importance as the global expansion of democracy has been offset by high economic performance of some countries, such as China and Russia. At the same time, the global economic crisis of 2008-2009 has put in question the feasibility of the free market model and to emphasize the need for a stronger government role. In the current global climate, claims are sometimes made that neither free markets nor democratic governments will permit economic performance, and that the authoritarian regimes are better suited to achieve such goals.

There is a broad literature on the interrelationship between economic growth and democracy that has produced conflicting arguments and support on these points. Some have referenced higher growth rates of countries with politically repressive regimes while others have shown a positive impact of democracy on growth (Clague et al., 1996; Minier, 1998; Tavares and Wacziarg, 2001, etc...). Existing literature has concentrated mainly on the effects of democracy on economic growth. However, the number of studies on democratization and its impact on financial outcomes remains limited. Particularly, the impact of democratic transition (hereafter DT) on financial development (hereafter FD) – i.e. the existence of deep and stable credit markets in an economy – has not been empirically explored.

The aim of this research is twofold. First, it addresses the possible impact of transition to a representative government on financial outcomes. Second, it investigates the dynamic, i.e. short run and long run effects, of such transition on FD.

The countries considered in the analysis are only those which have experienced a DT between 1960 and 2000. We use the “combined polity score” - polity2 - provided by the Polity IV database (Marshall et al., 2009) to detect changes from autocratic regime to a democratic one. The largest sample includes 48 events of DT over the period<sup>3</sup> 1960-2000. We use a random-effects panel regression model to assess the relationship between transition to a democratic system and banking sector development. Our results show that (i) DT is associated with additional benefits of FD, (ii) financial and trade liberalization boost banking sector development, (iii) regime stability is associated with an increased level of FD (iv) real growth and ethnolinguistic fractionalization tend to reduce FD, (v) Government expenditure seems to further banking sector development although the result is not robust. Concerning legal factors, it appears that legal origin lost its significance in explaining the financial development once we control for political factors. Besides, our results highlight effects of DT over different horizons. Particularly, we found that on the short term, DT presents a slight impact that depends on the dimension of FD, since DT is not the priority of the country - other political and social stakes override. On the long run, the move to a democratic system has a positive effect on FD as a democratic political process dilutes the degree of elite control over economic resources.

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<sup>3</sup> Initial sample includes 120 events between 1800 and 2010. But we exclude those before 1960 (subject to data availability for FD), those after 2000 (in order to study long term impact on FD), those related to a democratic experience during less than 5 years, and those for which data on FD is not available.

Our research contributes to the related literature in several ways. First, it is the first paper that considers the issue of DT and its impact on financial outcomes. Besides, it contributes to the existing literature by examining FD in a political economy framework; actually, this research extends the relatively scarce literature on the political determinants of FD, as only a limited number of studies have investigated the democracy-financial growth nexus (Huang, 2005; Barth et al., 2006, Girma and Shortland, 2008; Yang, 2011). Finally, it is the first paper that considers dynamic effects of DT on FD.

The remainder of this paper is structured as follows. Section 2 reviews the literature on democracy and economic and financial outcomes. Section 3 describes the data and variables used. The methodology is discussed in Section 4 and results are presented and discussed in Section 5. Section 6 presents robustness tests and further evidence and Section 7 concludes.

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## 2. LITERATURE REVIEW

Existing literature has highlighted advantages of democratic political systems in achieving prosperity goals. Prominent researches and influential academics stressed out that this prosperity is mainly attained through economic and financial performance. However, part of the researches have contradicted this viewpoint and claimed that empirical evidence does not entirely support this relationship. On the other hand, a huge literature has evoked the positive role of FD in stimulating economic growth. One of the pioneering researches is best illustrated by Joseph Schumpeter (1912) who stressed out that the use of the society's savings, important for resource allocations, productivity and hence long term economic growth, is mainly determined by financial systems.

The ideology that FD is a precursor for economic growth raises an important question: how did some countries succeed in developing their financial systems in order to enhance their economic development, while others remain financially underdeveloped?

A first response to this question could be found in La porta et al. (1997) law and finance theory. This theory implies that differences in FD could be traced in part to the differences in investor protections against expropriation by insiders. The authors conclude that common law countries are more financially developed than civil law countries. Particularly, the seminal work of La Porta et al. (1997, 1998, and 2008) showed that, common law origin countries seem to better protect minority investors, and additionally, these countries benefit from highly developed equity markets.

A critic to the law and finance theory is that the development of financial sectors changes across the time while the legal origin does not (Rajan and Zingales, 2003). The authors de-emphasize the role of fixed factors, such as legal tradition, and emphasize the role of political factors that change through time. They propose an interest group theory according to which financial and industrial incumbent could be unreceptive to arm's length markets since arm's length financial markets can stimulate competition in markets and can even suppress the incumbency value. Thus, FD will probably occur when only the country's political structure changes dramatically, or when the incumbents want development to take place.

Generally, the politics and finance view emphasizes that parties who hold power or who have the force to press on the political persons, will influence policies and financial reforms according to their private interests and according to their own advantage (Marx, 1972; North,

1990; Olson, 1993). Political economy theories of FD argue that, FD and access to capital by foreign entrants may be blocked in countries where elites influence political decisions. In fact, in financially underdeveloped countries, elites will have access to capital through a system of banks relationship.

Furthermore, according to the politics and finance view, centralized and powerful government will be more willing to realize the elite's interests than a decentralized, open, and competitive political system (Olson, 1993). In fact, the latter reported out that gains occurred from investments in projects and long term transactions will be channeled to the real sector only when the government is believed to last and is inhibited from expropriating individuals' rights and property rights. Most importantly, Olson (1993) proved that the conditions which are required to guarantee the protection of individual rights are the same conditions needed to have a lasting democracy. Evidently, as denoted by Siegle et al. (2004) democracy involves principles such as freedom of speech, respect of rule of law, protection of individual rights and security of property rights against violation from the government and the ruling elites. As the foregoing reasoning suggests, the political regime in which these rights are believed to be respected and to last across generations is a durable democratic political system. Clague et al. (1996) extended the Olson's (1993) view and noted that because democracy better protects property rights, it will provide greater incentives for investment.

Moreover, democracy is believed to enhance FD since it encourages systems of political checks. In fact, private citizens would be unable to enter into private or public arrangements since their rights are not guaranteed. In fact centralized and powerful states will be more receptive to satisfy elites' demands than a more competitive political system endowed with checks and balances (Acemoglu, 2003). The foregoing reasons explain why democracy can have a direct effect on FD. In the same vein, it is stressed out that the degree of political power depends on the level of political accountability. Thus, an expected extrapolation would be that more political rights will reduce the degree of political power and hence increase the development of financial markets.

On the other hand, economic literature distinguishes two effects of democratic institutions on economic outcomes: The development theory and the sceptical theory. The development theory emphasizes the role of democratic institutions in stimulating economic performance. It stands out that first; redistribution does not necessarily have a negative impact, since taxation revenues could be used to subsidize investment. Saint-Paul and Verdier (1993) and Bourgoignon and Verdier (2000) modelled how redistribution can spur growth through increased public spending on education. Second, democratic institutions result in reduction of transaction costs because they enhance the efficiency of financial markets (Wittman, 1989). Third, as democratic institutions encourage foreign entrants because markets are more open, it helps new firms utilize more efficiency productivity innovations leading to a more developed economic sector (Acemoglu, 2003).

Sceptical approaches of democracy underline the inefficiencies of representative government. Prominent researchers highlight the threat caused by democratic regimes. Huntington (1968) warned about the dangerous effects of increased demands for current consumption. Buchanan and Tullock (1962) evoked the agency conflict between elected politicians and the public. They described the possibility of a big state satisfying the demands of the masses. Finally, democracy could lead to inefficient outcomes since it allows different elite groups to compete for political influence (Becker, 1983).

Existing literature on the relationship between democracy and financial outcomes has been subject to controversy. A number of studies reported that democracy promotes FD for the different arguments discussed above. A survey of these studies shows that democracy is mainly measured by two variables: Freedom House political rights index and Polity 2 index (Huang, 2005; Barth et al., 2006; Rodriguez and Santiso, 2007; Miletkov and Wintoki, 2008; Girma and Shortland, 2008; Yang, 2011). Besides other studies measure the democracy by either legislative completion which is an index of the degree of competitiveness of the last legislative election, ranging from 1 (non-competitive) to 7 (most competitive), or checks which measures the number of influential veto players in legislative and executive initiatives (Beck et al., 2003; Girma and Shortland, 2008 ).

Another line of empirical researches de-emphasize the prominent role of democracy on financial outcomes. Bordo and Rousseau (2006) reported a strong, independent effect of proportional representation, frequent elections, female suffrage, and political stability on the size of the financial sector. Rajan and Ramcharan (2011) found that elites may restrict FD in order to limit access to finance, and they are able to do so even in countries with high degree of political liberalization. Cherif and Gazdar (2010) , focusing on a panel of 14 MENA countries, found that the institutional environment as captured by a composite policy risk index do not appear to be a driving force for the stock market capitalization in the region.

A serious shortcoming of this literature is that it only addresses long-run relationships. It does not directly answer what happens during and in the immediate aftermath of transitions to democracy.

This paper contributes to the existing literature by looking at the impact of the DT on FD. To our knowledge, only Girma and Shortland (2008), Batuo et al. (2009) and Huang (2010) investigated this issue and found that the degree of democracy is a significant explanatory factor in determining FD. Particularly, Girma and Shortland (2008) identified a regime change when the polity indicator changes by 1 or more from one year to the next, or if a period of regime transition ends with the establishment of a democratic regime. Thus, they did not succeed in isolating the effect of transition on financial growth. Batuo et al. (2009) studied the effect of political liberalization measured by a change in the polity variable from negative to positive value in a sample of African countries. The goal of their study is to examine the impact of political liberalization on FD rather than the transition from autocratic to democratic regime. Finally, Huang (2010) used a before and after approach to quantify changes in FD following the democratization year. In his study, he did not perform elaborated techniques to test the foregoing relationship.

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### **3. DATA AND VARIABLES USED**

#### **3.1 THE MEASURE AND DATA FOR DEMOCRATIC TRANSITION**

To select which countries have moved from authoritarian regime to democracy, we use the PolityIV Database (Marshall et al., 2009), as a selection standard. The Polity indicator “polity2” measures the degree of democracy based on competitiveness of political participation, the openness and competitiveness of executive recruitment, and constraints on the chief executive. It varies from -10 (strongly autocratic) to 10 (strongly democratic) and defined as the democracy score minus the autocracy score. To precisely identify the countries

and exact timing of a permanent DT, we primarily located significant changes in the Polity indicator over the period 1960-2000, i.e., the Polity2 index increases from a negative to a positive value. Second, we have cross-checked our results against previous studies which examined other political science and historical resources, as well as election databases. This further allows gathering complementary information on countries for which data are not available in the polity database.

Then, to avoid potential bias due to instability or lack of consolidation, we considered only episodes of transitions for which the pre-democratic era lasted at least five years and the democratic period continued at least for five years. The stability requirement is essential as noted by Huntington (1993) who stated that “. . . Stability is a central dimension in the analysis of any political system.” For those countries that democratized after 1995, we validated that they fulfil the stability requirement beyond the year 2000. Some countries, however, have two transitions in the same direction. We deal with the transitions in these countries in two different ways: the transition period is either excluded because the stability requirement is not fulfilled or included with the transitions in the same direction assumed independent (as if each transition applied to a different country).

Our methodology yields 59 permanent democratization episodes over the period 1960–2000. The final and largest sample includes 48 events of DTs due to data unavailability for our dependent variable and control variables (the list of countries and their DT years are reported in appendix 1).

Based on the subsequent analysis, we define the DT variable as a binary variable that takes the value of 1 for the year and subsequent years of DT, and 0 otherwise. The coefficient associated to this variable measures the development of the banking sector attributed to DT. For the different arguments discussed above, we expect it to have a positive impact on FD. Further, we study the dynamic effects of democratization: we look at the short run and at the long run effects of DT on FD. Actually, although we expect that the relationship between DT and FD being positive, this association might not be monotonic. Moreover, Friedrich Hayek (1960) stated that: "It is in its dynamic, rather than in its static, aspects that the value of democracy proves itself. As is true of liberty, the benefits of democracy will show themselves only in the long run, while its more immediate achievements may well be inferior to those of other forms of government." Thus, we would expect no favourable and/or negligible impact of DT on FD, on the short term, since the latter is not the priority of the country - other political and social stakes override. On the long run, the move to a democratic system should have a positive effect on FD as a democratic political process dilutes the degree of elite control over economic resources.

To quantify both the short and the long-run effects of DT, we apply two different methodologies. First, we rerun the baseline model over a short run horizon ((-5; 0) (0; 5)) then over a long run horizon ((-5; 0) (5; 10)). Second, we follow Rodrik and Wacziarg (2005) and distinguish between the early phase of the transitions and the subsequent phase. Hence, we include 2 dummy variables in the baseline model:

- Short run Democracy (Short democ) which takes a value of 1 in the year(s) and subsequent 5 years of democratization, and 0 otherwise.

- Long run Democracy (Long democ) which takes a value of 1 in the years following the first 5 years of major DTs, unless the process is interrupted by another major regime change, in which case the dummy is coded as 1 until the interruption, and 0 otherwise.

### 3.2 THE MEASURE AND DATA FOR FINANCIAL DEVELOPMENT

We assess banking sector development of DT by considering various measures: (i) bank's credit to private sector (specification 1) which equals financial intermediary credits to the private sector divided by the GDP. Thus it is an indicator of financial intermediary's activity. Furthermore, previous studies (Levine et al., 2000; Beck et al., 2003; Bekaert et al., 2005) promote the use of private credit as a consistent measure of FD. It is also the preferred measure of FD in the recent literature since it excludes credit to public enterprises and other government agencies which may not be allocated by expected return and which are often controlled by elites. (ii) Deposit money bank assets to GDP (specification 2) which equals the ratio of total domestic assets of deposit money banks divided by GDP. It is an indicator of the overall size of banking sector. (iii) Liquid liabilities to GDP (specification 3) which equals currency plus demand and interest-bearing of banks and other financial intermediaries divided by GDP. It is a general indicator of the size of financial intermediaries relative to the size of the economy. It captures the degree of monetization of the financial system. (iv) Aggregate index (specification 4); in fact, taken together, these three measures of bank development provide more information on the banking sector than if one uses only a single indicator. We use principal components analysis to produce this aggregate index. The measure is based on the three indicators described above and accounts for 75% of their variation. The weights resulting from principal components analysis are 0.57 for private credit 0.60 for bank assets to GDP and 0.55 for liquid liabilities.

Data on domestic credit to private sector are obtained from the World Bank database, while data on alternative measures are taken from Beck et al. database on FD and structure (2010).

### 3.3 THE MEASURE AND DATA FOR CONTROL VARIABLES

We include two sets of control variables. The first set consists of time-varying variables:

- *Real GDP growth (real growth)*: The effect is ambiguous. On the one hand, rapid growth may be associated with more FD. On the other hand, according to 'conditional convergence', more developed countries, as reflected in GDP per capita, tend to have slower credit growth (Levine and Renelt, 1992; Easterly and Levine, 1997). Thus, it is likely that the faster growing countries will have lower levels of FD. We would therefore expect a negative coefficient for real growth in our FD regressions. Data on real growth are obtained from the World Bank database.

- *Trade openness (TO)*. It is the sum of exports and imports in percentage of GDP. Theory suggests that international trade openness will necessary bring new firms into the domestic market. The competition enhancing effects of new entrants will contribute to reduce the incumbents' rents which will negatively impact their cash flows, making them reliant on external finance. This will indirectly promote the FD (Rajan and Zingales, 2003). We would therefore expect a positive coefficient for (TO). Data on this variable are from the World Bank database.

- *Capital openness (KO)*. It is the capital openness index developed by Chinn and Ito (2010). Theory suggests that capital account liberalization affects the development of financial systems through several channels. First, it may contribute to diminish financial repression in protected financial markets, allowing the real interest rate to rise to its competitive market equilibrium. Second, it allows domestic and foreign investors to engage in more portfolio diversification. Thus, financial liberalization may reduce the cost of capital and increase its availability for the borrowers. Consequently, we expect a positive coefficient on (KO).

- *Government spending (Gov exp)*. It is total government consumption expenditure divided by GDP. This variable is introduced to take into account the influence of fiscal policy. The sign is ambiguous. On one hand, La Porta et al. (1999) found that the quality of government institutions is positively associated with the size of government. Thus one should expect that (Gov exp) to have a positive effect on FD since property rights protection and contract enforcement will encourage investments and private credit. Besides, government increase expenditure on economic and physical infrastructure may reduce production costs, increases private sector investment and profitability of firms, thus fostering economic and financial growth (Abdullah, 2000; Al-Yousif, 2000; Ranjan and Sharma, 2008; Cooray, 2009). On the other hand, government expenditure may have a distortion effect on FD. If government increases borrowing (especially from the banks) in order to finance its expenditure; it will be done on the account of the private sector, thus reducing private investment. That's why; many studies (Laudau, 1986; Barro, 1991; Engen and Skinner, 1992; Folster and Henrekson, 2001) suggest that large government expenditure has negative impact on economic growth. Data on government expenditure are from the World Bank database.

- *Regime stability (RS)*. It is the number of years that have elapsed since a major regime transition. Its use is based on the basis that FD requires a certain level of trust and reputation. People in governments with frequent changes are scared from expropriation behaviours; that's why in such governments people will prefer to hold physical assets instead of financial assets. So we expected political stability to have a positive effect on FD. Regime stability is measured by the variable "durable" from Polity IV.

The second set of control variables includes variables that proxy for the historical determinants of property rights:

- *Dummy variables* for English, French and German law as proxies for legal origins. La Porta et al., (1997, 1998) argue that countries with British legal tradition better protect the quality of property rights institutions than the French civil law countries. German and Scandinavian law come somewhere in between. Data come from La Porta et al. (1998).

- *Ethnolinguistic fractionalization (Ethno frac)*. It is an index constructed by La Porta et al. (1998) and reflects the probability that two randomly selected individuals from a population belonged to different groups. Ethnic diversity may have a negative impact on institutional aspects since societies with high degree of ethnic fractionalization tend to find it more difficult to abide on a set of rules that aim to prevent elites from abused power; hereby exhibiting a negative effect on FD (Alesina et al., 2003). We expect the coefficient on this variable to be negative.



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## 4. METHODOLOGY

For empirical testing, and in a first stage, we conduct a “before-and-after” analysis, completed by several statistical tests, to compare an individual country’s short-term (1 to 5 years) and long-term (5 to 10 years) FD under autocratic and democratic regimes. In a second stage, we use a pooled regression approach. First, it helps increasing the number of observations, degrees of freedom and decreasing collinearity among explanatory variables especially when the number of years is low. Second, pooling allows controlling for exogenous shocks common to all events (time effects) and reduces the omitted variable bias (unit effects). However, simple pooled regression assumes homogenous behavior of endogenous variable for all individuals in the sample and hence may not be well designed to capture relationships between dependant variable and explanatory variables<sup>4</sup>. This is not clearly the case for the variable *FD*, as it varies considerably between countries and years. Fixed and random effects estimation methods are more suitable in this latter case. Using the Hausman test, the random effect specification is preferred. Besides, the use of fixed effects model raises two issues. First, the fixed specification does not capture the effect of invariant time variables. Second, unit dummies are associated with reduced cross sectional variance. Therefore, we use a random-effects regression model that controls for both observed and unobserved cross-country heterogeneity.

To assess the impact of DT on FD, we estimate the following panel model:

$$Y_{it} = \alpha + \beta DemocTran_i + \delta X_{it} + \mu Z_i + e_{it}$$

Where  $\alpha$  is the constant,  $e_{it}$  the error term, and the subscripts  $i$  and  $t$  are the event of DT and the period, respectively. For each event, we consider five years before and ten years after the DT.  $Y_{it}$  is the dependent variable corresponding to the level of banking sector development . The independent variable of interest is the DT variable. The vector  $X$  contains time-varying variables whereas  $Z$  includes time fixed variables.

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## 5. EMPIRICAL RESULTS

### 5.1 STYLIZED FACTS

This section presents key stylised facts on the FD behaviour in association with DT event. First, we conduct a “before-and-after” event study to compare an individual country’s FD performance under autocratic and democratic regimes (Table (1)). We use the principal components index measure since it is the most representative measure of the general level of financial sector development. The five year average FD preceding DT is compared with its average during the first five, the last five and the ten years under democracy for 34 countries. Results show that the ten year average FD increases by 23% on average after the initiation of a DT and more than half of the sample countries exhibit an improvement in FD. Moreover, after democratization, FD appears to increase progressively in 1–5 years, followed by a bound in 5–10 years. The different performance between countries may be due to the role of other factors such as macroeconomic factors and the general investment climate that would play an important role in boosting FD. On average, these results tend to support the evidence that

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<sup>4</sup> Hsiao test rejects the homogeneity of data structure.

transition to a democratic system is associated with an increase in the FD level, although the result is only substantial for a subset of countries.

**Table1. Change in FD before and after DT**

Country/Period	[-5;0)	(0;5]	DIFF1	[-5;0)	(5;10]	DIFF2	[-5;0)	(0;10]	DIFF 3
<b>Cape verde</b>	-1,14448	0,639800	1,784288	-1,144488	1,776121	2,920609	-1,144488	1,20796	2,352448
<b>Central African Republic</b>	-1,76269	-1,750426	0,012273	-1,762699	-1,84269	-0,07999	-1,762699	-1,79655	-0,03386
<b>Chile</b>	1,963992	1,05265	-0,91134	1,963992	2,05913	0,095138	1,963992	1,55589	-0,40810
<b>Croatia</b>	0,524988	2,1272	1,602211	0,524988	3,98923	3,464241	0,524988	3,058217	2,533228
<b>Dominican republic</b>	-0,26040	0,062653	0,323061	-0,260408	-0,08739	0,173011	-0,260408	-0,01237	0,248036
<b>Ecuador</b>	-0,97797	-0,528396	0,449579	-0,977975	-0,77843	0,199536	-0,977975	-0,65341	0,324557
<b>El salvador</b>	-0,17176	0,616868	0,788636	-0,171768	-0,25621	-0,08444	-0,171768	0,180326	0,352095
<b>Ghana</b>	-1,88743	-1,088312	0,79912	-1,887432	-0,69828	1,189142	-1,887432	-0,89330	0,994131
<b>Greece</b>	-0,42479	0,581533	1,006330	-0,424796	2,027489	2,452285	-0,424796	1,304511	1,729307
<b>Guatemala</b>	-0,84840	-1,151026	-0,30262	-0,848402	-1,09937	-0,25097	-0,848402	-1,12520	-0,27679
<b>Guinea_Bisseau</b>	-2,05382	-1,744652	0,309172	-2,053824	-1,17526	0,878555	-2,053824	-1,45996	0,593863
<b>Haiti</b>	-0,87626	-0,848521	0,027746	-0,876268	-0,46546	0,410799	-0,876268	-0,65699	0,219273
<b>Honduras</b>	-0,05503	0,192844	0,247880	-0,055036	0,553703	0,608740	-0,055036	0,373273	0,428310
<b>Hungary</b>	1,197735	1,163365	-0,03437	1,197735	0,469766	-0,72796	1,197735	0,816565	-0,38116
<b>Indonesia</b>	2,086468	0,704910	-1,38155	2,086468	0,263935	-1,82253	2,086468	0,484423	-1,60204
<b>Iran</b>	-0,27414	-0,369799	-0,09565	-0,274149	0,205138	0,479287	-0,274149	-0,08233	0,191818
<b>Korea rep</b>	1,165845	1,502192	0,336347	1,165845	1,679682	0,513837	1,165845	1,590937	0,425092
<b>Lesotho</b>	-0,24459	-0,329627	-0,08503	-0,244596	-0,62245	-0,37786	-0,244596	-0,47604	-0,23144
<b>Madagascar</b>	-1,09421	-1,217482	-0,12326	-1,094215	-1,40852	-0,31430	-1,094215	-1,31300	-0,21878
<b>Malawi</b>	-1,35381	-1,806526	-0,45270	-1,353819	-1,58702	-0,23320	-1,353819	-1,69677	-0,34295
<b>Mali</b>	-1,21605	-1,341153	-0,12510	-1,216051	-1,08596	0,130089	-1,216051	-1,21355	0,002494
<b>Mexico</b>	-0,49080	-0,008159	0,482642	-0,490801	-0,54763	-0,05683	-0,490801	-0,27789	0,212905
<b>Mozambique</b>	-1,16382	-1,447118	-0,28329	-1,163822	-1,07487	0,088947	-1,163822	-1,26099	-0,09717
<b>Nepal</b>	-1,05500	-0,556455	0,498551	-1,055007	0,280364	1,335371	-1,055007	-0,13804	0,916961
<b>Nigeria</b>	-1,49218	-1,163688	0,328495	-1,492183	-0,47700	1,015177	-1,492183	-0,82034	0,671836
<b>Pakistan</b>	0,438254	0,304045	-0,13420	0,438254	0,591328	0,153073	0,438254	0,447686	0,009432
<b>Panama</b>	1,81038	1,931575	0,121195	1,81038	4,057583	2,247203	1,81038	2,994579	1,184199
<b>Paraguay</b>	-1,32646	-0,585106	0,741355	-1,326462	-0,05475	1,271702	-1,326462	-0,31993	1,006529
<b>Philippines</b>	0,010123	-0,618919	-0,62904	0,010123	0,733596	0,723473	0,010123	0,057338	0,047215
<b>Poland</b>	1,549351	-0,389732	-1,93908	1,549351	-0,19460	-1,74395	1,549351	-0,29216	-1,84152
<b>Senegal</b>	-1,07444	-0,657319	0,417125	-1,074445	-0,12080	0,953644	-1,074445	-0,38906	0,685384
<b>Spain</b>	3,935118	4,541274	0,606156	3,935118	4,322343	0,387225	3,935118	4,431808	0,49669
<b>Uruguay</b>	1,717906	0,680520	-1,03738	1,717906	-0,12204	-1,83994	1,717906	0,279240	-1,43866
<b>Zambia</b>	-1,06801	-1,779929	-0,71191	-1,068013	-1,59996	-0,53194	-1,068013	-1,68994	0,621932
<b>Average</b>	-	-	0,077517	-	0,226782	0,400797	-	0,065142	0,239157
	0,174014	0,096497	16	0,174014	81	59	0,174014	64	42
	7	62		78			78		

Note: This table compares the FD performance for 34 countries before and after democratization. Column 1 and 2 are the average of FD 5 years before or after transition. DIFF1 is the difference between them. Column 4 and 5 are the average of FD 5 years before and the (5-10) years after transition. DIFF2 is the difference between two columns. Columns 7 and 8 are the average of FD 5 years before transition and (0-10) years after transition. DIFF3 is the difference between columns 7 and 8. In the lower section the average is calculated for DIFF1, DIFF2, and DIFF3. The FD measure is the Principal components analysis measure.

Moreover, using different measures of FD, we compare the 5 year average FD before DT with its mean during the first five, the last five and the ten years under democracy (table (2)). Results confirm the above findings. Actually, FD rises after the DT and the difference is positive and significant across the different indicators of FD except the private credit measure for which the difference was not significant. Ultimately, Table (3) gives a more comprehensive picture of the economic and financial evolution before and after DT. Average growth in real GDP increases from 2% to 3% between the periods [-5,0] to [0,10]. The period after DT in turn is characterized by a considerably higher foreign direct investment which increases from 0.7% to 2% in average. Eventually, DT was followed by an increase in capital and trade openness.

**Table 2. Average FD before and after DT**

	(-5;0)	(0;5)	DIFF 1	P value	(-5;0)	(5;10)	DIFF 2	P value	(-5;0)	(0;10)	DIFF 3	P value	Event
(1)	0,2557	0,2427	-0,013	0,4332	0,2557	0,2744	0,0187	0,2948	0,2557	0,2586	0,0028	0,8518	48
(2)	0,2859	0,3008	0,0148	0,4839	0,2859	0,3442	0,0582 (**)	0,0123	0,2859	0,3225	0,0365 (**)	0,0622	33
(3)	0,2926	0,3232	0,0305 (**)	0,0457	0,2926	0,3553	0,0626 (***)	0,0001	0,2926	0,3392	0,0465 (***)	0,0008	32
(4)	-0,174	-0,096	0,0775	0,6075	-0,174	0,2267	0,4007 (**)	0,0147	-0,174	0,0651	0,2391 (*)	0,0834	34

Note: this table compares average FD, using several measures, before and after democratization without including the year of DT.

**Table 3. Economic and financial indicators before and after DT in the largest sample**

Indicators	Mean	Sd.deviation	Min	Max
<b>Pre DT (years [-5,0])</b>				
<b>KO</b>	-.7326169	1.199294	-1.843764	2.477618
<b>Gov exp</b>	.1391057	.0665828	.0384421	.357307
<b>Real growth</b>	.0236015	.0538465	-.29589	.1289576
<b>TO</b>	.5517165	.3144384	.1154567	2.339413
<b>FDI</b>	.0073705	.0170351	-.1220843	.0827954
<b>Post DT (years[0,10])</b>				
<b>KO</b>	-.4745979	1.17762	-1.843764	2.477618
<b>Gov exp</b>	.1306171	.0598862	.0297554	.4295028
<b>Real growth</b>	.0346912	.0424795	-.2809998	.1672882
<b>TO</b>	.6355135	.3732826	.1234638	2.546058
<b>FDI</b>	.0241002	.0417757	-.0275744	.3611379

Note: we do not include the year of DT in our calculation.

## 5.2 THE REGRESSION RESULTS

Table (4) presents the results of the effect of DT on the four measures of FD discussed above<sup>5</sup>. Interestingly, the DT variable has a positive and a highly significant coefficient (at 1% level) throughout all the specifications, indicating that transition to a democratic regime tends to increase the level of FD. Actually transition to democracy enhances FD because it requires a high quality of legal system and the security of property rights, which are necessary for steady growth and which provide greater incentives for investment (Olson (1993)). Moreover, democracy improves FD since it encourages systems of political check out and

<sup>5</sup> We do not consider year dummy variables. We also run the regressions with year dummies and the main results are unchanged.

gives priority to citizens. Democracy protects citizen's individual rights and property rights against violation from the government and the ruling elites (Siegle et al., 2004). In fact, private citizens would be unable to enter into private or public arrangements since their rights are not guaranteed (Acemoglu, 2003).

Of the control variables, the (RS) has a positive and significant coefficient all over the specifications. Countries which have not experienced a major regime transition for a long time tend to have higher levels of FD than those which have gone through major upheaval, more recently. In fact, instability hinders a nation from implementing well structured institutions or can at best lead to inefficiency of such institutions even if built. So, regime stability seems to promote FD. The coefficient of (KO) is positively significant across model specifications and the result is consistent with theory. It shows that financial liberalization boost FD since it diminishes financial market repression, increase diversification opportunities and reduces the cost of capital. The coefficient on (TO) is also positive, although the result is not significant across all the specifications. It somewhat supports the evidence that international trade will bring FD. In fact, the competition enhancing effects of new entrants will contribute to reduce the incumbents' rents. The lower profits for incumbent firms will negatively impact their cash flows, making them reliant on external finance, which will have an indirect positive effect on FD. Real GDP growth is negatively linked to FD. This indicates that the fastest growing countries tend to have the least-developed financial sectors. This result is in line with the conditional convergence theory (Levine and Renelt, 1992; Easterly and Levine, 1997) according to which, faster growing countries will have lower levels of FD. The sign of the coefficient associated to (Gov exp) is positive but not significant through all the specifications. We could conclude, with some reservations, that public spending tends to shape FD since it increases the quality of the institutional environment and reduces the transaction costs in financial markets. Of the different legal origins, coefficients are globally not significant in almost the specifications. British common law and civil law do not succeed to explain FD. There is some evidence that once political regime characteristics are controlled for, legal origin is no longer a prominent factor explaining FD. Also consistent with our hypothesized prediction, the coefficient of (*ethno frac*) is negative and statistically significant in all model specifications. This confirms the fact that political competition in ethnically heterogeneous societies could retard the FD in a country.

**Table 4. DT and control variables regression on different measures of FD**

	(1)	(2)	(3)	(4)
DT	0.0232*** (0.00692)	0.0385*** (3.54e-05)	0.0513*** (0)	0.340*** (6.20e-07)
KO	0.0222*** (2.48e-06)	0.0108** (0.0403)	0.00790* (0.0610)	0.0953** (0.0143)
RS	0.00266*** (6.55e-08)	0.00173*** (0.000920)	0.00253*** (7.55e-09)	0.0241*** (2.41e-09)
Gov exp	0.173* (0.0872)	0.441*** (0.000513)	0.0117 (0.908)	1.075 (0.252)
Real growth	-0.356*** (4.36e-06)	-0.394*** (3.49e-06)	-0.385*** (1.37e-08)	-3.619*** (7.71e-09)
TO	0.0174 (0.487)	0.0820*** (0.00350)	0.161*** (0)	0.977*** (4.00e-06)
Ethno frac	-0.249*** (0.000358)	-0.311*** (4.26e-05)	-0.210** (0.0115)	-2.648*** (0.000205)
English_law	0.110 (0.208)	0.0573 (0.533)	-0.0146 (0.884)	0.551 (0.522)
French_law	0.175** (0.0195)	0.0914 (0.248)	0.0103 (0.905)	0.927 (0.212)
German_law	0.347** (0.0228)	0.195 (0.218)	-0.0214 (0.902)	1.502 (0.313)
Intercept	0.152** (0.0356)	0.202*** (0.00817)	0.265*** (0.00108)	-0.755 (0.280)
Observations	768	627	619	619
Number of countries	48	45	45	45
R <sup>2</sup>	0.3632	0.3958	0.2745	0.3834

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

Tables (5) and (6)<sup>6</sup> report respectively dynamic short term and long term effects of democracy on FD. Results support the evidence that, on the short run, transition to a democratic system may slightly boost the country's FD (denoted by low coefficients) although it tends to affect in different way diverse dimensions of FD. On the one hand, it seems to stimulate the importance of the financial services performed by commercial banks relative to the size of the economy ( bank deposit assets to GDP) and the ability of banks to mobilize funds to finance entrepreneurs (bank liquid liabilities to GDP) as well as the general level of financial sector development (captured by the components index), whereas it tends to produce no immediate effect on the quantity of funds that is channeled through the banking system to the private sector (domestic credit to private sector/GDP). We explain the latter result by the fact that, on the short term, democracy is not well consolidated which enables elites to keep on adjusting decisions to their will. Thus, they could orient the development of private sector credits according to their vested interests. In fact, transitory democracies are vulnerable to expropriations that present similar dangerous affects on property rights as the supremacy of an autocrat (Clague et al. (1996)). Furthermore, Johnson and Wilson (2000) suggest that in societies with little democratic traditions and civil discipline, decision makers are exposed to informal connections and are under the pressure of elites and groups seeking for illegal rents.

<sup>6</sup> Tables (5) and (6) do not include the year dummies variables.

Under these conditions, loan decisions are influenced by the strength of pressures from interest groups. Loans will thus be expanded to enterprises with good political connection, which are generally public enterprises controlled by lobbies. On the contrary, all the coefficients become positive, larger in magnitude and highly significant in the long run, which confirms our hypothesis. Therefore, DT seems to shape FD in the long term. Of the different control variables, (KO) and (Gov exp) lost significance. (RS) and (TO) coefficients' remain positive and significant across all the specifications except in the second short run specification where they lost significance. Real growth and ethnolinguistic fractionalization are still significant in all model specifications. Finally, the sign and significance of the different legal origin variables remain unchanged.

**Table 5. Short run impact of DT on different measures of FD**

	(1)	(2)	(3)	(4)
DT	0.0109 (0.244)	0.0175* (0.0955)	0.0371*** (5.88e-07)	0.202*** (0.00380)
KO	0.0159** (0.0121)	0.00788 (0.289)	0.00417 (0.435)	0.0596 (0.235)
RS	0.00201*** (9.51e-05)	0.000693 (0.219)	0.00157*** (0.000195)	0.0152*** (0.000127)
Gov exp	0.152 (0.188)	0.437*** (0.00298)	0.0308 (0.772)	1.295 (0.194)
Real growth	-0.242*** (0.00241)	-0.281*** (0.00175)	-0.272*** (2.14e-05)	-2.455*** (4.37e-05)
TO	0.00892 (0.745)	0.0312 (0.359)	0.111*** (1.47e-05)	0.665*** (0.00552)
Ethno frac	-0.233*** (0.000968)	-0.295*** (0.000109)	-0.207*** (0.00786)	-2.394*** (0.000572)
English_law	0.0693 (0.435)	-0.00472 (0.959)	-0.00642 (0.945)	0.169 (0.839)
French_law	0.146* (0.0555)	0.0340 (0.667)	0.0207 (0.797)	0.616 (0.391)
German_law	0.306** (0.0471)	0.147 (0.343)	-0.0137 (0.932)	1.265 (0.374)
Intercept	0.183** (0.0144)	0.287*** (0.000231)	0.287*** (0.000168)	-0.395 (0.563)
Observations	528	407	399	399
Number of countries	48	43	43	43
R <sup>2</sup>	0.3426	0.3763	0.2544	0.3625

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

**Table 6. Long run impact of DT on different measures of FD**

	(1)	(2)	(3)	(4)
DT	0.0280*** (0.00449)	0.0446*** (9.25e-05)	0.0555*** (2.55e-10)	0.354*** (1.24e-05)
KO	0.0196*** (0.000426)	0.000367 (0.956)	-0.00101 (0.847)	0.00781 (0.871)
RS	0.00253*** (4.64e-06)	0.00150** (0.0178)	0.00262*** (2.79e-07)	0.0217*** (4.03e-06)
Gov exp	0.151 (0.198)	0.253 (0.124)	-0.243* (0.0592)	-0.800 (0.499)
Real growth	-0.380*** (0.000136)	-0.356*** (0.00336)	-0.383*** (5.15e-05)	-3.555*** (4.57e-05)
TO	0.0366 (0.223)	0.151*** (4.51e-05)	0.210*** (0)	1.450*** (1.29e-07)
Ethno frac	-0.231*** (0.00123)	-0.305*** (8.71e-05)	-0.217** (0.0158)	-2.548*** (0.000517)
English_law	0.0893 (0.319)	0.0772 (0.413)	-0.00895 (0.934)	0.565 (0.524)
French_law	0.161** (0.0366)	0.120 (0.139)	0.00869 (0.926)	0.943 (0.218)
German_law	0.337** (0.0309)	0.209 (0.196)	-0.0348 (0.853)	1.389 (0.364)
Intercept	0.153** (0.0418)	0.154* (0.0553)	0.267*** (0.00246)	-0.906 (0.215)
Observations	528	426	420	420
Number of countries	48	45	45	45
R <sup>2</sup>	0.3419	0.3833	0.2736	0.3670

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

Table (7) reports the dynamic effects of DT using our second methodology of binary classification. Results support our findings using the first methodology. In fact, estimated coefficient on the short run democracy variable remains insignificant with the private sector credit measure, while it becomes significant with the other FD proxies. The coefficient on the long run democracy is positive and significant through all the specifications proving the fact that democratizations seem to have sizable long-run benefits. On the other hand, the sign and the significance of the coefficients on control variables remain unchanged except the capital openness variable which lost significance on the third specification.

**Table 7. Short run and long run effects of DT on different measures of FD**

	(1)	(2)	(3)	(4)
Short Democ	0.0142 (0.138)	0.0207** (0.0422)	0.0366*** (5.86e-06)	0.213*** (0.00430)
Long Democ	0.0318*** (0.000795)	0.0545*** (4.99e-08)	0.0647*** (0)	0.454*** (6.02e-10)
KO	0.0211*** (8.45e-06)	0.00869* (0.0971)	0.00614 (0.141)	0.0803** (0.0373)
RS	0.00242*** (1.66e-06)	0.00122** (0.0211)	0.00206*** (3.72e-06)	0.0201*** (1.09e-06)
Gov exp	0.181* (0.0717)	0.455*** (0.000279)	0.0211 (0.834)	1.152 (0.214)
Real growth	-0.352*** (5.60e-06)	-0.385*** (4.17e-06)	-0.379*** (1.40e-08)	-3.571*** (7.82e-09)
TO	0.0103 (0.684)	0.0609** (0.0313)	0.142*** (9.84e-10)	0.816*** (0.000135)
Ethno frac	-0.249*** (0.000365)	-0.310*** (5.72e-05)	-0.209** (0.0125)	-2.639*** (0.000266)
English_law	0.111 (0.206)	0.0613 (0.511)	-0.0114 (0.910)	0.579 (0.508)
French_law	0.175** (0.0197)	0.0917 (0.254)	0.00994 (0.909)	0.924 (0.220)
German_law	0.346** (0.0232)	0.196 (0.223)	-0.0206 (0.906)	1.509 (0.318)
Intercept	0.157** (0.0303)	0.213*** (0.00568)	0.276*** (0.000703)	-0.658 (0.353)
Observations	768	627	619	619
Number of countries	48	45	45	45
R <sup>2</sup>	0.3594	0.3795	0.2637	0.3756

Where Short democ is the short run DT variable, Long democ is the long run DT variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

## 6. ROBUSTNESS TESTS

The results given so far stand that a successful DT is associated with considerable (particularly long-term) FD gains. In this section we provide some additional evidence, checking at the same time for the sensitivity of our estimates<sup>7</sup>. First, we change the five year stability requirement condition to ten years. Thus, we exclude transition episodes that are not maintained over ten years. Results are reported in table (8). Moreover, since the empirical growth literature has considered numerous variables that explain differences in FD, we need to control for omitted variables bias. Thus, we augment our basic specification with other regressors (foreign direct investment to GDP (FDI) and lagged banking crisis dummy variable). Results are reported in table (9). Further, in table (10), we control for the initial level of FD since the latter may condition the level of FD after the DT. Hence, we introduce in each regression the initial level of FD which corresponds to the level achieved right before

<sup>7</sup> All robustness test result tables are reported in appendix 2.



the year of transition. Moreover, as pointed out by Persson and Tabellini (2007) a high initial value of polity2 might have an independent effect on the financial consequences of regime changes. For this reason, we introduce the initial value of polity2 ( $Polity2_0$ ) to capture the level of democracy in the year 0. Results are reported in table (11). Furthermore, to test the robustness of our findings, we consider indicators from the stock market development; namely stock market capitalization (specification 1) and the value of traded shares (specification 2), each divided by GDP, and re-run the models in Table (4). The data used are from Beck et al. database on FD and structure (2010). Results are reported in table (12). Additionally, it is interesting to assess to what extent our methodology produces different results, using a five-year average of our data. We average our indicators of FD and our explanatory variables over five years so as to reduce the influence of outliers as well as to abstract from business cycle influences. We therefore have only three observations per event. Results are reported in table (13). Finally, we redefine permanent DT events based, not on the polity2 index, but on the trichotomous Freedom House political status which jumps from "not free" to either "partly free" or "free". We re-run models in tables (4), (5), (6) and (7). Results are reported in tables (14), (15), (16) and (17).

Table (8) denotes that changing the five year requirement to ten years does not change the results in any significant way. Interestingly, the DT variable still highly significant and the coefficient slightly grows in magnitude. Coefficients of the control variables still the same as for the baseline model except (KO) variable which lost significance on the second specification. Further, adding control variables does not change our results in any significant way. (FDI) and banking crisis variables have the expected sign although the result is not robust across all the specifications. Table (10) demonstrates that although we control for the initial level of FD, the effect of DT on FD remain positive and significant throughout all the specifications. Besides, Initial level of FD variable is positive and significant though all the specifications. Except (KO), (Ethno frac) and (Gov exp) which lost significance in some specifications, the other control variables still have the same sign and significance as in the baseline model.

Results in table (11) reveal that while controlling for the level of democracy achieved after the transition, the coefficient of the DT variable is still positive and significant all over the specifications. Moreover, we find that the initial level or intensity of the democracy does not seem to play a role in explaining the level of FD achieved after the transition. Coefficients of the control variables remain unchanged. Furthermore, using stock market measures as alternative indicators of FD produce the same result concerning our interest variable. The transition to a democratic system seems to further the development of financial markets. The controls (KO) and (RS) confirm their roles of being conducive to FD, and all estimates are significant. However, the other control variables lost significance. This later result could be due to the fact that as the majority of countries included in the sample consist of developing countries, the use of stock market measures might not be a good representative of FD. Moreover, this may be due to a significant reduction in sample size in these two specifications.

On the other hand, averaging the data over five years does not change the result in all most the specifications. The DT variable remains positive and significant. On the control variables, (KO) remains positive and significant except in the third specification where it lost significance. All the control variables remain unchanged except (Gov exp) which lost significance. Finally, when using the freedom house index as an alternative measure to

identify the DT years, the DT variable remain positive and highly significant across all the specifications except in the first one where it lost significance. Different control variables remain significant as in the baseline model, except (KO), (Gov exp) and (TO) which lost significance in some specifications. Moreover, using the two methodologies, conclusions regarding the dynamic effects of DT on FD remain unchanged.

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## 7. CONCLUSION

The purpose of this paper is to examine the relationship between democracy and financial outcomes. Particularly, it raises the question of whether DT stimulates FD by using a panel of a maximum of 48 events of DT. The preliminary evidence by a “before-and-after” approach indicates that in general DTs are typically preceded by low FD, but followed by a long-run boost in FD. Using various FD measures; our evidence points towards a dominant role played by political regime change in the development of the financial sector. Particularly, this is important on the long run horizon. In fact, the results indicate that on the short term, DT affects in different way different aspects of financial development; especially, it promotes bank liquid liabilities and deposit money bank assets but does not shape the private sector financial indicator. However, on the long run, the move to a democratic system has a positive effect all over the different aspects of FD, as a democratic political process dilutes the degree of elite control over economic resources.

Besides, our findings highlight the importance of regime stability, financial and real openness in promoting the development of the financial sector; as well as, the distortion effect played by real growth and ethnolinguistic fractionalization. Finally, we found that once the effects of the political regime characteristics are taken into account, the legal origin of a country becomes less important in determining financial sector performance.

Our findings have important implications. From a theoretical standpoint, this is part of a larger problem of institutional transplantation, and our study intends to facilitate its understanding. It offers direct support to development theories of democratic government that emphasize the beneficial aspects of representative institutions. From a policy perspective, our results suggest that transition to a representative government is associated with substantial financial development benefits especially on the long run horizon. This result has an important implication for DT countries. Indeed, it means that, beyond the establishment of democratic government, these countries will also pay attention to their political stability and institutional fulfillments especially in short run because we believe that on the long run democracy will be institutionalized. In the contrary case, the risk for these countries is to not fully benefit different dimensions of FD from DT, on the short run. In fact, in societies with little democratic traditions and civil discipline, decision makers are exposed to informal connections and are under the pressure of elites and groups seeking for illegal rents. Under these conditions, loan decisions are influenced by the strength of pressures from interest groups. Loans will thus be expanded to enterprises with good political connection, which are generally public enterprises controlled by lobbies (Johnson and Wilson, 2000).

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**Appendix 1. List of countries used in the largest sample and their years of DT relaying on the Polity2 index**

Country	Year of DT
Argentina	1983
Albania	1992
Bolivia	1982
Brazil	1985
Benin	1991
Bangladesh	1991
Central African republic	1993
Comoros	1990
Chili	1989
Cape Verde	1991
Croatia	1999
Dominican Republic	1978
Djibouti	1999
El Salvador	1982
Ecuador	1979
Guatemala	1986
Guyana	1992
Ghana	1996
Greece	1974
Guinea-Bissau	1994
Honduras	1980
Hungary	1989
Haiti	1994
Iran	1997
Indonesia	1999
Korea republic	1987
Lesotho	1993
Mexico	1994
Mali	1992
Mozambique	1994
Madagascar	1991
Malawi	1994
Nicaragua	1990
Nepal	1990
Nigeria	1999
Panama	1989
Peru	1979
Portugal	1974
Poland	1989
Pakistan	1988
Philippine	1986
Paraguay	1989
Romany	1990
Senegal	2000
Spain	1976
Uruguay	1985
Uganda	1980
Zambia	1991

## Appendix 2. Robustness test results

**Table 8. DT and control variables regression on different measures of FD (ten years stability condition)**

	(1)	(2)	(3)	(4)
DT	0.0275*** (0.00333)	0.0481*** (2.75e-06)	0.0587*** (0)	0.405*** (5.35e-08)
KO	0.0210*** (2.64e-05)	0.00857 (0.128)	0.00931** (0.0378)	0.0829** (0.0434)
RS	0.00283*** (4.45e-08)	0.00208*** (0.000157)	0.00274*** (2.42e-09)	0.0264*** (3.77e-10)
Gov exp	0.177* (0.0920)	0.477*** (0.000284)	0.0320 (0.761)	1.306 (0.175)
Real growth	-0.386*** (2.37e-06)	-0.430*** (1.41e-06)	-0.390*** (4.12e-08)	-3.786*** (6.14e-09)
TO	0.0116 (0.656)	0.0677** (0.0209)	0.152*** (2.85e-10)	0.865*** (7.78e-05)
Ethno frac	-0.273*** (0.000248)	-0.339*** (3.13e-05)	-0.224** (0.0131)	-2.851*** (0.000194)
English_law	0.129 (0.155)	0.0788 (0.406)	0.000259 (0.998)	0.724 (0.415)
French_law	0.190** (0.0140)	0.109 (0.182)	0.00869 (0.923)	1.017 (0.183)
German_law	0.350** (0.0246)	0.201 (0.213)	-0.0197 (0.912)	1.515 (0.319)
Intercept	0.150** (0.0427)	0.194** (0.0128)	0.262*** (0.00172)	-0.854 (0.232)
Observations	720	586	578	578
Number of countries	45	42	42	42
R <sup>2</sup>	0.3743	0.3860	0.2580	0.3734

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.



**Table 9. DT and control variables regression on different measures of FD (with additional variables)**

	(1)	(2)	(3)	(4)
DT	0.0225*** (0.00927)	0.0365*** (0.000115)	0.0480*** (1.28e-10)	0.307*** (8.88e-06)
KO	0.0224*** (2.11e-06)	0.0108** (0.0413)	0.00809* (0.0538)	0.0963** (0.0130)
RS	0.00264*** (8.89e-08)	0.00176*** (0.000822)	0.00245*** (2.28e-08)	0.0237*** (5.11e-09)
Gov exp	0.180* (0.0760)	0.421*** (0.00100)	0.0252 (0.806)	1.099 (0.244)
Real growth	-0.364*** (3.08e-06)	-0.397*** (3.37e-06)	-0.401*** (3.26e-09)	-3.753*** (2.20e-09)
TO	0.0116 (0.657)	0.0783*** (0.00561)	0.152*** (5.34e-11)	0.896*** (2.52e-05)
Ethno frac	-0.249*** (0.000422)	-0.311*** (1.95e-05)	-0.209** (0.0118)	-2.635*** (0.000131)
English_law	0.110 (0.213)	0.0576 (0.513)	-0.0181 (0.856)	0.526 (0.527)
French_law	0.175** (0.0210)	0.0935 (0.218)	0.00965 (0.911)	0.931 (0.195)
German_law	0.348** (0.0242)	0.201 (0.186)	-0.0209 (0.904)	1.530 (0.287)
FDI	0.0714 (0.522)	0.183 (0.142)	0.209** (0.0333)	2.361*** (0.00927)
Banking crisis <sub>t-1</sub>	-0.00644 (0.504)	0.00685 (0.517)	-0.0145* (0.0804)	-0.0801 (0.298)
Intercept	0.155** (0.0339)	0.201*** (0.00609)	0.272*** (0.000771)	-0.708 (0.296)
Observations	768	627	619	619
Number of countries	48	45	45	45
R <sup>2</sup>	0.3606	0.3935	0.2751	0.3795

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, FDI is net inflow of foreign direct investment to GDP, Banking crisis<sub>t-1</sub> is the lagged banking crisis variable, \*\*\*, \*\* and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

**Table 10. DT and control variables regression on different measures of FD (with initial FD)**

	(1)	(2)	(3)	(4)
DT	0.0224*** (0.00897)	0.0402*** (3.19e-05)	0.0525*** (0)	0.340*** (1.49e-06)
KO	0.0146*** (0.00111)	-0.000500 (0.925)	-0.000335 (0.937)	0.0180 (0.652)
RS	0.00261*** (1.11e-07)	0.00158*** (0.00334)	0.00229*** (2.37e-07)	0.0221*** (9.78e-08)
Gov exp	0.0939 (0.308)	0.263** (0.0328)	-0.0722 (0.468)	0.199 (0.830)
Real growth	-0.347*** (7.82e-06)	-0.363*** (0.000102)	-0.369*** (5.90e-07)	-3.304*** (1.84e-06)
TO	0.0302 (0.143)	0.0707*** (0.00562)	0.137*** (8.31e-11)	0.887*** (5.05e-06)
Ethno frac	-0.0960*** (0.00530)	-0.0530 (0.169)	0.000434 (0.990)	-0.318 (0.323)
English_law	0.111*** (0.00648)	0.106** (0.0346)	-0.00431 (0.926)	0.514 (0.220)
French_law	0.0971*** (0.00626)	0.127*** (0.00387)	0.0273 (0.505)	0.713* (0.0519)
German_law	0.175** (0.0152)	0.150** (0.0328)	0.0502 (0.444)	1.125* (0.0529)
DF <sub>0</sub>	0.752*** (0)			
DF <sub>0</sub>		0.803*** (0)		
DF <sub>0</sub>			0.841*** (0)	
DF <sub>0</sub>				0.789*** (0)
Intercept	-0.0363 (0.366)	-0.131** (0.0185)	-0.0675 (0.216)	-1.281*** (0.00177)
Observations	768	556	540	540
Number of countries	48	35	34	34
R <sup>2</sup>	0.8400	0.8996	0.8310	0.8752

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, FD<sub>0</sub> is the initial value of financial development, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

**Table 11. DT and control variables regression on different measures of FD (with initial Polity2)**

	(1)	(2)	(3)	(4)
DT	0.0232*** (0.00701)	0.0385*** (3.83e-05)	0.0511*** (0)	0.339*** (6.93e-07)
KO	0.0222*** (2.45e-06)	0.0113** (0.0332)	0.00807* (0.0558)	0.0965** (0.0132)
RS	0.00266*** (6.80e-08)	0.00174*** (0.000928)	0.00252*** (8.62e-09)	0.0241*** (2.67e-09)
Gov exp	0.173* (0.0873)	0.450*** (0.000386)	0.0164 (0.872)	1.118 (0.234)
Real growth	-0.357*** (4.35e-06)	-0.389*** (4.96e-06)	-0.383*** (1.74e-08)	-3.600*** (9.94e-09)
TO	0.0173 (0.489)	0.0833*** (0.00285)	0.162*** (0)	0.982*** (3.49e-06)
Ethno frac	-0.249*** (0.000409)	-0.311*** (1.40e-05)	-0.211*** (0.00929)	-2.649*** (0.000129)
English_law	0.111 (0.210)	0.0650 (0.453)	-0.00798 (0.935)	0.595 (0.477)
French_law	0.176** (0.0208)	0.0937 (0.209)	0.0122 (0.885)	0.940 (0.192)
German_law	0.342** (0.0296)	0.146 (0.336)	-0.0609 (0.724)	1.234 (0.402)
Polity2 <sub>0</sub>	-0.00129 (0.875)	-0.0130 (0.112)	-0.0105 (0.246)	-0.0716 (0.358)
Intercept	0.158* (0.0561)	0.261*** (0.00135)	0.314*** (0.000463)	-0.423 (0.583)
Observations	768	627	619	619
Number of groups	48	45	45	45
R <sup>2</sup>	0.3636	0.4234	0.2950	0.3957

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, Polity2<sub>0</sub> is the polity2 value in year 0, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

**Table 12. DT and control variables regression on different measures of Stock market development**

	(1)	(2)
DT	0.126*** (2.54e-09)	0.0477*** (5.78e-07)
KO	0.0480*** (0.000158)	0.0166*** (0.00115)
RS	0.00704*** (0.000765)	0.00375*** (5.20e-05)
Gov exp	0.186 (0.558)	0.0259 (0.834)
Real growth	0.267 (0.251)	0.104 (0.286)
TO	-0.0133 (0.805)	-0.0304 (0.137)
Ethno frac	0.0513 (0.529)	0.0311 (0.230)
English_law	0.00826 (0.922)	-0.0533* (0.0537)
French_law	0.0755 (0.280)	-0.0278 (0.230)
German_law	0.208* (0.0707)	0.241*** (5.94e-11)
Intercept	-0.0733 (0.432)	0.0141 (0.679)
Observations	271	284
Number of countries	26	26
R <sup>2</sup>	0.0143	0.6142

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.

**Table 13. DT and control variables regression on different financial measures (averaged data)**

	(1)	(2)	(3)	(4)
DT	0.0312* (0.0844)	0.0554*** (0.00986)	0.0548*** (0.00331)	0.455*** (0.00445)
KO	0.0220** (0.0319)	0.0215* (0.0780)	0.0115 (0.289)	0.155* (0.0951)
RS	0.00358*** (0.00139)	0.00342*** (0.00839)	0.00309*** (0.00985)	0.0357*** (0.000492)
Gov exp	-0.0954 (0.694)	0.441 (0.173)	-0.167 (0.571)	0.0400 (0.987)
Real growth	-0.908*** (0.00370)	-1.168*** (0.00204)	-0.788** (0.0188)	-9.874*** (0.000606)
TO	0.0896* (0.0911)	0.0989* (0.0822)	0.176*** (0.000922)	1.254*** (0.00670)
Ethno frac	-0.249*** (0.000449)	-0.304*** (0.000126)	-0.206** (0.0114)	-2.568*** (0.000373)
English_law	0.109 (0.223)	0.0549 (0.569)	-0.00499 (0.960)	0.559 (0.523)
French_law	0.182** (0.0179)	0.0891 (0.283)	0.0193 (0.821)	0.952 (0.207)
German_law	0.378** (0.0155)	0.245 (0.139)	0.0136 (0.936)	1.934 (0.200)
Intercept	0.143* (0.0939)	0.195** (0.0420)	0.273*** (0.00412)	-0.800 (0.338)
Observations	144	122	121	121
Number of countries	48	45	45	45
R <sup>2</sup>	0.3415	0.3728	0.2569	0.3568

Where DT is the democratic transition variable, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. All data are averaged over 5 years. Values in parentheses are p-values.

**Table 14. DT and control variables regression on different measures of FD (with FH index)**

	(1)	(2)	(3)	(4)
DT	0.0110 (0.135)	0.0463*** (5.58e-07)	0.0415*** (6.93e-08)	0.324*** (1.76e-06)
KO	0.0225*** (7.54e-08)	0.00686 (0.215)	0.00656 (0.147)	0.0781* (0.0500)
RS	0.00205*** (2.60e-07)	0.00243*** (3.87e-07)	0.00156*** (0.000120)	0.0199*** (2.77e-08)
Gov exp	0.0225 (0.815)	0.398*** (0.00322)	0.189* (0.0885)	1.110 (0.255)
Real growth	-0.349*** (9.06e-07)	-0.433*** (1.44e-06)	-0.352*** (1.83e-06)	-3.444*** (1.22e-07)
TO	-0.0145 (0.523)	0.0427 (0.155)	0.122*** (9.01e-07)	0.512** (0.0188)
Ethno frac	-0.309*** (0.000118)	-0.376*** (0.000411)	-0.283*** (0.00434)	-2.948*** (0.000522)
English_law	0.141 (0.119)	0.0942 (0.410)	0.0338 (0.751)	0.823 (0.367)
French_law	0.199** (0.0107)	0.118 (0.237)	0.0414 (0.656)	1.025 (0.198)
German_law	0.326** (0.0340)	0.191 (0.322)	-0.0251 (0.889)	1.376 (0.371)
Intercept	0.208*** (0.00411)	0.219** (0.0162)	0.274*** (0.00111)	-0.550 (0.446)
Observations	639	523	519	518
Number of countries	40	37	37	37
R <sup>2</sup>	0.3676	0.3652	0.3256	0.3766

Where DT is the democratic transition variable using Freedom house index to decide on years of DT, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. All data are averaged over 5 years. Values in parentheses are p-values.

**Table 15. Short run impact of DT on different measures of FD (with FH index)**

	(1)	(2)	(3)	(4)
DT	-0.00180 (0.803)	0.0194** (0.0370)	0.0275*** (5.44e-05)	0.150** (0.0177)
KO	0.0133** (0.0106)	0.00660 (0.355)	0.00303 (0.557)	0.0279 (0.558)
RS	0.00153*** (6.06e-05)	0.00135*** (0.00406)	0.000980*** (0.00540)	0.0127*** (0.000103)
Gov exp	-0.0781 (0.449)	0.276* (0.0696)	0.170 (0.122)	0.380 (0.709)
Real growth	-0.327*** (4.31e-06)	-0.424*** (8.91e-06)	-0.275*** (6.61e-05)	-3.042*** (1.98e-06)
TO	0.0538** (0.0236)	0.102*** (0.00395)	0.171*** (9.41e-11)	1.242*** (3.07e-07)
Ethno frac	-0.304*** (0.000177)	-0.350*** (0.000924)	-0.271*** (0.00579)	-2.829*** (0.000846)
English_law	0.0928 (0.310)	0.00454 (0.968)	0.0199 (0.851)	0.305 (0.739)
French_law	0.187** (0.0176)	0.0607 (0.541)	0.0587 (0.525)	0.892 (0.263)
German_law	0.291* (0.0610)	0.134 (0.480)	-0.0204 (0.908)	1.084 (0.479)
Intercept	0.200*** (0.00660)	0.271*** (0.00331)	0.237*** (0.00464)	-0.629 (0.386)
Observations	439	340	336	335
Number of countries	40	36	36	36
R <sup>2</sup>	0.3906	0.3643	0.2939	0.3824

Where DT is the democratic transition variable using Freedom house index to decide on years of DT, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. All data are averaged over 5 years. Values in parentheses are p-values.

**Table 16. Long run impact of DT on different measures of FD (with FH index)**

	(1)	(2)	(3)	(4)
DT	0.0158* (0.0829)	0.0532*** (2.57e-06)	0.0405*** (1.12e-05)	0.351*** (2.28e-05)
KO	0.0238*** (4.72e-06)	0.00195 (0.780)	0.000267 (0.962)	0.0384 (0.445)
RS	0.00186*** (0.000112)	0.00234*** (5.11e-05)	0.00155*** (0.00137)	0.0187*** (1.60e-05)
Gov exp	0.0894 (0.467)	0.310* (0.0994)	0.00952 (0.950)	0.190 (0.889)
Real growth	-0.323*** (0.000895)	-0.482*** (0.000118)	-0.369*** (0.000260)	-3.472*** (0.000135)
TO	-0.0433 (0.144)	0.0475 (0.260)	0.152*** (9.76e-06)	0.572* (0.0627)
Ethno frac	-0.300*** (0.000415)	-0.385*** (0.000561)	-0.291*** (0.00472)	-2.967*** (0.000769)
English_law	0.127 (0.184)	0.113 (0.348)	0.0326 (0.769)	0.852 (0.369)
French_law	0.180** (0.0292)	0.136 (0.195)	0.0352 (0.716)	0.997 (0.227)
German_law	0.306* (0.0606)	0.197 (0.330)	-0.0415 (0.824)	1.252 (0.432)
Intercept	0.230*** (0.00317)	0.217** (0.0258)	0.291*** (0.00104)	-0.437 (0.567)
Observations	439	355	351	350
Number of countries	40	37	37	37
R <sup>2</sup>	0.3120	0.3529	0.3366	0.3653

Where DT is the democratic transition variable using Freedom house index to decide on years of DT, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. All data are averaged over 5 years. Values in parentheses are p-values.



**Table 17. Short run and long run effects of DT on different measures of FD (with FH index)**

	(1)	(2)	(3)	(4)
Short democ	0.00495 (0.544)	0.0318*** (0.00148)	0.0289*** (0.000507)	0.223*** (0.00241)
Long democ	0.0174** (0.0351)	0.0616*** (9.12e-10)	0.0543*** (7.08e-11)	0.427*** (6.39e-09)
KO	0.0223*** (9.37e-08)	0.00688 (0.207)	0.00666 (0.136)	0.0790** (0.0454)
RS	0.00192*** (2.12e-06)	0.00211*** (1.15e-05)	0.00126*** (0.00201)	0.0175*** (1.28e-06)
Gov exp	0.0300 (0.755)	0.413*** (0.00201)	0.200* (0.0678)	1.201 (0.213)
Real growth	-0.344*** (1.24e-06)	-0.423*** (1.91e-06)	-0.344*** (2.41e-06)	-3.380*** (1.59e-07)
TO	-0.0210 (0.360)	0.0204 (0.500)	0.103*** (3.82e-05)	0.361 (0.101)
Ethno frac	-0.310*** (0.000115)	-0.378*** (0.000479)	-0.284*** (0.00332)	-2.961*** (0.000403)
English_law	0.142 (0.115)	0.100 (0.388)	0.0390 (0.708)	0.865 (0.336)
French_law	0.199** (0.0108)	0.119 (0.242)	0.0421 (0.642)	1.032 (0.188)
German_law	0.325** (0.0344)	0.192 (0.328)	-0.0246 (0.888)	1.380 (0.362)
Intercept	0.212*** (0.00346)	0.232** (0.0123)	0.285*** (0.000527)	-0.462 (0.516)
Observations	639	523	519	518
Number of countries	40	37	37	37
R <sup>2</sup>	0.3622	0.3482	0.3168	0.3588

Where Short democ is the short run DT variable using Freedom House index to select years of DT, Long democ is the long run DT variable using Freedom House index to select years of DT, KO is capital openness index, RS is regime stability, Gov exp is government final consumption expenditure divided by GDP, real growth is GDP real growth on annual basis, TO is trade openness, Ethno frac is the index of ethnolinguistic fractionalization, English, French and German law are binary variables reflecting legal origin, \*\*\*, \*\*and \* indicate significance at 1%, 5%, and 10% levels. Values in parentheses are p-values.