The Effects of Financial Crises on Political Institutions

Jerg Gutmann*, Katharina Pfaff** and Stefan Voigt***

Abstract:

The real economic effects of financial crises have been analyzed frequently. In this paper, we go one step further: we ask whether financial crises are significantly associated with a change in institutional quality. When public finance is under significant stress, sustaining sufficiently high levels of public spending to retain institutional quality might be exceedingly difficult. But rulers may also face incentives to infringe upon rights to overcome threats to their regime. To proxy for institutional quality, we rely on basic human rights, judicial independence and democracy. It turns out that financial crises do have a significant negative effect on the human rights records of the affected countries, particularly in autocracies. In contrast, there is no significant association between crises and judicial independence. It might be rational for (autocratic) regimes to increase repression, as we also find some evidence that financial disasters can trigger democratization.

Key Terms: Financial Crises, Basic Human Rights, Transition to Democracy.

JEL classification: G01, K40, O17, O43.

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1 Introduction

Good institutions have often been hailed as a precondition for sustained economic development (see, e.g., North 1990). And there is, indeed, a high correlation between realized levels in the rule of law – as one very general proxy for institutional quality – and income (as, e.g., documented in Gutmann and Voigt 2015a). Ever since Lipset (1959) published the so-called modernization hypothesis, there has been an intense debate on the causality at work here: does high income enable societies to afford good institutions or are good institutions a precondition for reaching high income levels?

In this paper, we do not strive to make yet another contribution to the modernization debate. Instead, we ask whether severe financial crises are followed by significant deteriorations in institutional quality. In a previous paper (Gutmann and Voigt 2015b), we found that natural disasters can have negative consequences on human rights, i.e. one important aspect of the quality of institutions. Instead of examining the human rights consequences of natural disasters, here we are interested in the human rights consequences of financial crises. In fact, we broaden our question as we also look into other dimensions of political institutions, such as judicial independence and democracy.

We find that financial crises are significantly correlated with deteriorations in reported levels of basic human rights, such as the absence of torture or killings. As could be expected, this effect is stronger in autocracies than in democracies. Regarding the association between financial crises and changes in judicial independence no significant correlation is found. But we do find some evidence that financial disasters can trigger democratization. We conclude that during serious financial crises, it is basic human rights that are most endangered.

This paper expands the literature on financial crises. As a consequence of the recent ‘Great Depression,’ many studies have been concerned with the macroeconomic effects of financial crises and the potential means to mitigate such consequences. Reinhart and Rogoff (2009), for example, ask whether there are recurring patterns in the emergence and spread of financial crises, whether different types of financial crises are closely linked to each other and whether there are good early predictors of such crises. Romer and Romer (2015) work in the opposite direction by asking what possible transmission channels translate problems in the financial sector into problems in the real economy. We add to this analysis by using financial crises as our explanatory variable and asking whether they are associated with changes in various aspects of political institutions.
2 Possible Effects of Financial Crises on Political Institutions

Before a number of conjectures are derived regarding the possible effects of financial crises on institutional quality, we propose a specific delineation of the term ‘financial crisis.’ Various types of crises are distinguished in the literature, which we follow suit here. Reinhart and Rogoff (2009) distinguish between (1) banking crises, (2) sovereign debt crises, (3) domestic debt crises, (4) currency crises, and (5) inflation crises. Note that this delineation does not include economic crises, which have been defined as a substantial contraction in per capita income (Barro and Ursúa 2012). Financial crises do, of course, lead to economic crises but the relationship between the two is not our concern here.

Financial crises usually imply severe constraints on government spending. As the provision of public goods – including the provision of an independent judiciary and basic human rights – is costly, they might only be provided with lower quality than before the onset of the crisis.

Staying in control by reducing the independence of the judiciary would be an extremely costly option for the incumbent. Even the most autocratic regimes are typically interested in an independent judiciary, since it facilitates more economic transactions, which is conducive to economic growth (Ginsburg and Moustafa 2008). We hence expect at most a small negative effect of financial crises on the independence of the judiciary.

We have argued that during crises, governments may lack the resources to uphold human rights. Wintrobe (1998) argues that autocrats have basically two tools at their disposal to facilitate their survival in office, loyalty and repression. By distributing perks to their constituents, autocrats can buy loyalty. Repression works by intimidating subjects and thus making sure that no meaningful opposition arises. Both tools are costly, but Wintrobe predicts that in times of financial hardship, autocrats are more likely to rely on repression. Regarding our issue, his model predicts that during financial crises, autocrats renge on basic human rights. Therefore, we expect a substantially larger negative effect of financial crises on human rights in autocracies than in democracies.

The question whether financial crises can cause regime change is closely related. Acemoglu and Robinson (2006:175) argue that autocratic elites will only consider to consent to democratization if the non-elites can credibly threaten their position. To threaten their position, the non-elites need to overcome the problem of collective action, which is easier during times of crises. Moreover, de facto political power that results from crises is transitory and incentivizes citizens to
revolt, if there is no credible transfer of political power to the majority of citizens, i.e. democratization. We thus hypothesize that financial crises might have a positive impact on countries’ chances to become democracies.

3 Data and Results

To test our hypotheses that financial crises have significant adverse political consequences (and particularly so in autocracies), we first need to find an appropriate empirical operationalization of the severity of financial crises. Here we use an indicator provided by Reinhart and Rogoff (2009), which covers 70 countries annually from 1800 to 2010. Their indicator is a simple sum reflecting the number of ‘types of financial crises’ that occur in a given year. Reinhart and Rogoff take into account banking, currency, debt, and inflation crises as well as stock market crashes and call this their BCDI+ index. We normalize this indicator between 0 and 1, where higher values indicate a more extended financial crisis. Moreover, we are interested in measuring the reactions of political regimes to these financial crises. As the data by Reinhart and Rogoff limit our analysis to 70 countries, we are interested in indicators for our dependent variables that combine high data quality with coverage of a long time period.

To proxy for the level of rule of law in a country, we rely on a cross-national latent measure of de facto judicial independence by Linzer and Staton (2014). The rule of law is admittedly a concept much broader than the mere independence of judges (see Voigt 2012), but this measure offers an unprecedented sample size by covering 200 countries from 1948 to 2012. To measure basic human rights, we rely on a latent human rights protection score by Fariss (2014), which we normalize between 0 and 1.

Finally, we use an indicator by Cheibub et al. (2010) to distinguish democracies from autocracies. The original data covers the period 1946 to 2008, but Bormann and Golder (2013) extend the dataset for more recent years. This indicator is important to distinguish the reactions of democratic and nondemocratic regimes, but it also allows us to test for the stability of regime types facing financial crises. When samples are split into autocracies and democracies, this refers to the type of political system at the end of the preceding year.

Table 1: Effects of Financial Crises

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>[1]</th>
<th>[2]</th>
<th>[2a]</th>
<th>[2b]</th>
<th>[3]</th>
</tr>
</thead>
<tbody>
<tr>
<td>DV (t-1)</td>
<td>0.985***</td>
<td>0.976***</td>
<td>0.977***</td>
<td>0.971***</td>
<td>0.864***</td>
</tr>
<tr>
<td></td>
<td>(222.73)</td>
<td>(257.28)</td>
<td>(92.57)</td>
<td>(176.84)</td>
<td>(54.67)</td>
</tr>
</tbody>
</table>
Financial Crisis (t)  
\[-0.000 \quad -0.011^{**} \quad -0.016^{**} \quad -0.008^{*} \quad 0.054^{*}\]
\[(-0.11) \quad (-3.18) \quad (-2.93) \quad (-2.10) \quad (2.07)\]
Financial Crisis (t-1)  
\[0.000 \quad 0.001 \quad -0.002 \quad 0.002 \quad -0.015\]
\[(0.00) \quad (0.58) \quad (-0.41) \quad (0.43) \quad (-0.53)\]
Financial Crisis (t-2)  
\[0.001 \quad 0.004 \quad -0.000 \quad 0.005 \quad 0.019\]
\[(0.50) \quad (1.55) \quad (-0.12) \quad (1.38) \quad (0.83)\]
Financial Crisis (t-3)  
\[-0.000 \quad 0.000 \quad 0.002 \quad -0.003 \quad -0.009\]
\[(-0.07) \quad (0.15) \quad (0.47) \quad (-1.01) \quad (-0.29)\]
Financial Crisis (t-4)  
\[0.001 \quad 0.005 \quad 0.002 \quad 0.003 \quad 0.003\]
\[(0.18) \quad (1.61) \quad (0.51) \quad (0.74) \quad (0.11)\]
Constant  
\[0.002 \quad 0.013^{***} \quad 0.012^{*} \quad 0.011^{**} \quad -0.047^{*}\]
\[(1.28) \quad (6.25) \quad (2.19) \quad (3.12) \quad (-2.25)\]

<table>
<thead>
<tr>
<th>Country FE</th>
<th>YES</th>
<th>YES</th>
<th>YES</th>
<th>YES</th>
<th>YES</th>
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<tr>
<td>Year FE</td>
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<td>YES</td>
<td>YES</td>
<td>YES</td>
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<tr>
<td>Countries</td>
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<td>70</td>
<td>48</td>
<td>57</td>
<td>70</td>
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<td>Observations</td>
<td>4083</td>
<td>4031</td>
<td>1621</td>
<td>2410</td>
<td>4195</td>
<td></td>
</tr>
</tbody>
</table>

Note: OLS regression coefficients, t-values in parentheses. Standard errors are clustered in countries. Regression results for model [1] and [3] by subsample and Arellano-Bond estimates for all models are available on request. HR = basic human rights protection. *, p<0.05; **, p<0.01; ***, p<0.001.

Table 1 presents the regression results estimated using OLS and clustered standard errors. OLS estimates are appropriate in panels with large T, as the Nickel (1981) bias from combining country fixed effects and lagged dependent variable becomes small and the OLS estimator can, due to its low RMSE, be expected to perform at least as good as alternative estimators (Beck and Katz 2011). In our sample the average country is represented over 58 to 60 years, which is considerably above the threshold of 20 years suggested by Beck and Katz (2011:342). We control for time lags of financial crises for the four preceding years, as financial crises can continue over several years and tend to cluster across time and space.

Our results show that the level of judicial independence is unaffected by financial crises. This holds in both autocracies and democracies. In contrast, countries provide less protection of basic human rights during financial crises, violations of which include torture, extrajudicial killings, disappearances, etc. The estimated coefficient is not very large, but it should be noted that we estimate the average effect in every crisis year. An enduring financial crisis would accordingly be predicted to reduce human rights over the course of four years by up to 0.04, which is equivalent to the difference in 2010 between Ireland and Singapore or that between Singapore and Botswana. Although this effect is also statistically significant in a subsample of democratic countries, it is twice as large under autocratic regimes. These results are highly plausible: If regimes, particularly autocratic ones, react to financial crises with means of repression this does not
imply sudden changes in structural aspects of the rule of law. Finally, we note that countries are more likely to democratize during a financial crisis, as argued by Haggard and Kaufman (1995) and Acemoglu and Robinson (2006), among others. Financial crises reduce the rents available for redistribution to buy loyalty, but they also limit the state’s capacity for repression. In combination with increased social unrest autocrats may see no alternative to initiating democratization or face a revolution.

Although we have argued for OLS as our preferred estimation technique, all models have also been estimated using the Arellano-Bond linear dynamic panel-data estimator with robust standard errors (Arellano and Bond 1991). As one would expect, the change in estimator has only minor effects on the coefficient estimates for financial crises, but the estimated standard errors increase. As a result, the negative effect of financial crises on human rights in the democracy sample and the effect on democracy itself are not statistically significant anymore. We attribute this, however, to the higher RMSE of the GMM estimator. The effect of financial crises on human rights in the full samples and the sample of autocracies is still statistically significant.

4 Conclusions and Outlook

In this paper, we ask whether financial crises can impact upon political institutions. We find that the most pronounced effect regards basic human rights but also that financial crises are frequently accompanied by processes of democratization. This paper is very brief and many questions remain to be dealt with. Here, we name only three: (1) the correlation between financial crises and human rights is uncovered relying on an aggregate indicator composed of five different types of crises. It would be interesting to know the effects of particular types of crises on human rights. (2) This paper has dealt with financial and not with economic crises. Yet, economic crises are frequently a consequence of financial crises. Hence, inquiring into the relationship between economic crises and political institutions may also offer interesting insights. (3) It would also be interesting to untangle the empirical relationship between increased repression and concessions toward democratization.

Appendix: Descriptive Statistics

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Mean</th>
<th>SD</th>
<th>Min</th>
<th>Max</th>
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<tbody>
<tr>
<td>Judicial Independence</td>
<td>4083</td>
<td>0,537</td>
<td>0,537</td>
<td>0,024</td>
<td>0,996</td>
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<tr>
<td>Human Rights</td>
<td>4031</td>
<td>0,437</td>
<td>0,174</td>
<td>0,032</td>
<td>0,991</td>
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<td>Democracy</td>
<td>4195</td>
<td>0,604</td>
<td>0,489</td>
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<td>1</td>
</tr>
<tr>
<td>Financial Crisis</td>
<td>4021</td>
<td>0,113</td>
<td>0,155</td>
<td>0,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Note: Financial crisis reported for intersection of the above samples.

References


