FINANCIAL FRICTIONS AND THE RULE OF LAW

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ABSTRACT

Using cross-country micro establishment-level data we document that crime and lack of access to finance are two major obstacles to business operation in poor and developing countries. In an otherwise standard model of production heterogeneity that integrates institutional differences in the degree of financial development and the rule of law, we quantify the effects of these institutions on aggregate outcomes and economic development. The model accounts for the patterns across establishments in access to finance and crime as obstacles to their operation. Weaker financial development and rule of law have substantial negative effects on aggregate output, reducing output per capita by 50 percent. Weak rule-of-law institutions substantially amplify the negative impact of financial frictions. While financial markets are crucial for development, an essential precondition to reap the gains from financial liberalization is that property rights are secure.