

The Political Economy of Shareholder Protection and Stock Market Development

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Abstract

This paper presents a political economy model where there is a two-way causal relation between investor protection and stock market development. Better investor protection induces companies to issue more equity and thereby leads to a broader stock market. In turn, more equity issuance expands the shareholder base and increases the political support for shareholder protection. This feedback loop can generate multiple equilibria, with investor protection and stock market size being positively correlated across equilibria. Using panel data for 47 countries, we document that there is a contemporaneous positive correlation between measures of investor protection and of stock market development. This result is robust to the inclusion of fixed effects and calendar year dummies, as well as to the use of instrumental variables to control for the endogeneity of investor protection.

JEL classification: G34, K22, K42.

Keywords: political economy, shareholder protection, corporate governance, anti-takeover legislation, takeovers, acquisitions.

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