How Well Do Institutional Theories Explain Firms’ Perceptions of Property Rights?

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What explains differences in property rights protection? Legal origin may be less important than believed, and firm characteristics more so

Protection of property rights is a key factor in the efficient operation of contracts and the development of financial institutions. The critical question is why some countries have managed to develop strong protection of property rights while others have not.

A substantial body of theoretical work tries to explain the historical determinants of these differences. There is also a growing body of empirical work that assesses the relative contribution of different historical determinants in the cross-country variation of property rights protection. The most influential work has emphasized the importance of legal traditions, initial endowments, ethnic fractionalization, and culture and religion.

A paper by Ayyagari, Demirgüç-Kunt, and Maksimovic takes a more micro approach, using firm-level survey data to study how well firm-level and institutional factors explain entrepreneurs’ perceptions of property rights protection. The authors use survey responses from more than 7,500 firms in 80 countries to compare the different theories and to examine the relative influence of firm effects compared with country effects. The analysis is based on variance decomposition, which allows the authors to focus directly on the relative importance of the different effects in explaining property rights without any assumptions on causality or structural analysis.

The paper evaluates four potential historical determinants of property rights protection. First, the law and finance view predicts that historically determined differences in legal traditions help explain differences in protection of property rights today. Focusing on the differences between the two most influential legal traditions, British common law and French civil law, this theory holds that legal traditions differ in the priority they attach to protecting the rights of private investors against the state. As colonization spread around the world, British colonizers brought with them a legal tradition that stressed private property rights protection, while French colonizers spread a legal tradition less conducive to such protection.

Second, the endowment view emphasizes the role of geography and the disease environment in shaping the institutional environment and the underlying property rights. In this view it is not the identity of the colonizer but the colonization strategy that determined the extent of property rights protection. According to this view, countries that are closer to the equator, with a more tropical climate, were more inhospitable to European settlers and therefore fostered extractive institutions rather than institutions that protect property rights.

Third, political theories predict that governments become more interventionist as the ethnic heterogeneity of countries increases, with the groups in power implementing policies that expropriate as much as possible from other ethnic groups. Thus the ethnic diversity view would predict that countries with greater ethnic fractionalization are less likely to protect property rights.

Fourth, many scholars argue that religion shapes national views on protection of property rights. For example, they argue that the Catholic religion fostered authoritarian societies with powerful bonds between church and state, limiting protection of private property rights. Thus the fourth view, culture and religion, predicts that differences in religion and in the systems of beliefs and culture that stem from such differences can explain differences in property rights protection across countries.

Finally, implicit in several of these theories is the prediction that some classes of firms will have their property rights better protected than others. In oligarchic societies, for example, large incumbent firms would be expected to have greater protection of property rights than smaller firms. But these firm-level differences are mostly downplayed by the institutional theories that focus on country-level differences. By considering property rights protection at the firm level, the paper sheds light on the likely importance of firm characteristics such as size, private ownership, incorporation, and industry classification.

The results show that the institutional variables explain about 50 percent of the cross-country variation in property rights protection, suggesting that current research on institutions does indeed address first-order effects. A country’s legal origin predicts property rights protection better than its religion, ethnic fractionalization, or natural endowments.

But this result depends critically on sample selection. Removing formerly socialist economies from the sample significantly reduces the explanatory power of legal origin. In this smaller sample ethnic fractionalization and endowments are more important in explaining the variation in property rights protection. Since formerly socialist economies have much more in common than legal tradition, these two variables are probably capturing country characteristics that are not necessarily caused by differences in legal systems.

Focusing on firm-level differences, the authors find that such variables as size, ownership structure, and organizational form are comparable in importance to institutional factors in explaining variations in property rights protection—and in some cases even more important. These results suggest that firm-level differences, which have received little attention in the literature, are also significant in explaining perceptions of property rights protection.