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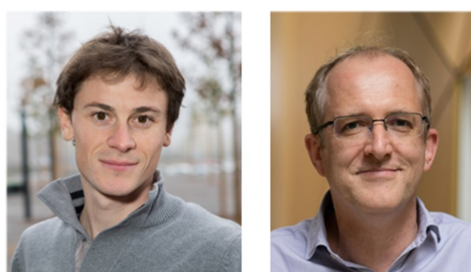
Elections Hinder Firms' Access to Credit



By Florian Léon and Laurent Weill*

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In a new paper[1], we investigate the influence of elections on access to credit for firms. We perform an investigation on large dataset of firms covering 44 developed and developing countries. We find that elections impair access to credit. Specifically, firms are more credit-constrained in election years and pre-election years as elections exacerbate political uncertainty. While lower credit demand is a tangible negative effect of elections, their occurrence per se does not seem to affect credit supply.

* **Florian Léon**, Foundation for Studies and Research on International Development (FERDI) and University Clermont-Auvergne; **Laurent Weill**, University of Strasbourg.

[1] https://helda.helsinki.fi/bof/handle/123456789/18295

Access to credit for companies matters

Access to credit is crucial for companies. Credit-constrained firms are unable to realize worthwhile projects and may find themselves unable to exploit investment opportunities when they arise. The lack of access to credit can hurt firm productivity (Butler and Cornaggia, 2011) and hamper firm growth (Fafchamps and Schündeln, 2013). Thus, good access to credit is beneficial for the expansion of the private sector and fosters aggregate productivity that contributes to economic growth.

A wide range of determinants of access to credit has been identified at both the firm level and the country level. The specific attributes of institutional frameworks influence financing obstacles, *directly* through such factors as the legal system's efficiency and quality of governance (Hsieh, Chen and Lin, 2019), and *indirectly* through relaxation of loan conditions through legal origins and protection of creditor rights (Bae and Goyal, 2009).

Elections can affect access to credit

Looking more closely at institutional characteristics that might influence financing obstacles for firms, recent evidence implicates the impact of elections on bank lending decisions (Dinc, 2005; Carvalho, 2014). The literature is divided as to the impact of elections on access to credit.

One view posits that *electoral episodes promote access to credit*, a notion with its roots in the political business cycle literature. Accordingly, politicians manipulate economic instruments to enhance their chances of reelection. This view predicts that incumbent governments will use loans as a strategic tool for re-election purposes. They would influence lending behavior of banks so that greater credit would be granted in election times.

Moreover, governments motivate banks to boost their lending during the run-up to an election. Besides their direct influence on state-owned bank lending, governments can influence private bank lending through a wide set of carrots and sticks, e.g. changes in banking regulation, threats of withdrawing banking licenses, and access to public entity loan market.

This view is empirically supported by the findings that state-owned bank lending is used to influence political outcomes. Lending of state-owned banks is correlated with the electoral cycle in the sense that state-owned banks increase lending in election years relative to private banks (Dinc, 2005; Englmaier and Stowasser, 2017). It is also supported by the finding that bank failures tend to be delayed during electoral episodes (Brown and Dinc, 2005).

A second view assumes that *elections impair access to credit*. Elections exacerbate political uncertainty as e.g. the identity of the winning party, the economic policies to be implemented, and the risk of political violence in election times are at stake. Political uncertainty has been shown to cause firms to delay their investments (Baker, Bloom, and Davis, 2016) and increase bank loan pricing (Francis, Hasan, and Zhu, 2014).

Elections can reduce credit demand as fewer firms request loans to finance their future prospects until the uncertainties about the forthcoming economic environment diminish. Further, elections could reduce the credit supply if banks are reluctant to lend in uncertain times. Thus, elections might limit access to credit by either reducing credit demand or credit supply through greater uncertainty. This hypothesis is empirically supported by the finding that firms reduce investment expenditures during election years (Julio and Yook, 2012).

The effect of elections on access to credit is therefore ambiguous from a theoretical perspective. But it is stunning – given the massive body of literature devoted to access to credit – that the influence of elections on access to credit has never been empirically investigated. In this paper, we shed light on the question of whether the occurrence of elections affects access to credit for firms.

What we do

We provide the first empirical investigation of the effect of elections on access to credit. We use firm-level data from a large cross-country dataset of firms of developed and developing countries extracted from the World Bank Enterprise Survey. These firm-level data also assure our sample is representative of the experience of small firms and internationally diverse. We combine this information with data on elections to investigate whether electoral episodes affect access to credit, examining whether election years, pre-election years, and post-election years are associated with changes in access to credit.

We define "credit-constrained firms" as firms that applied for credit and were denied or did not apply for credit because they were discouraged. A key advantage of our approach is that we can identify whether elections exert an impact separately on borrowers and on lenders. We can thus disentangle the supply-and-demand effects in the relation between elections and access to credit. It allows us to examine how elections influence access to credit and identify the mechanisms through which this effect takes place.

Furthermore, we can enrich this study of the impact of elections on access to credit by considering the firm-level and country-level characteristics that may affect it. We consider the potential influence of *political and financial system features* on the effects of elections on access to credit. On one hand, the degree of democracy of the political system affects the manipulation and uncertainty channels. Democratic regimes can have fewer opportunities to manipulate bank lending and may face less uncertainty because the risk of political violence after elections is lower. On the other hand, the degree of bank competition and the size of the financial system influence the possibilities for governments to manipulate bank lending. Large, competitive financial systems are associated with lower financing constraints for firms.

What we find

We find evidence that elections exert a detrimental influence on access to credit. Firms are most credit-constrained in election and pre-election years. These results support the *uncertainty channel* according to which the occurrence of elections deteriorates access to credit by enhancing political uncertainty. We demonstrate that this effect takes place on the borrower side, meaning that we observe greater borrower discouragement during electoral periods. By contrast, we find no impact on the lender side, meaning that elections do not overall affect credit supply.

Furthermore, political systems determine the detrimental effects of elections. Borrower discouragement is amplified in more democratic countries. Financial systems also matter. The detrimental impact of elections is stronger when the size of the financial system is larger and the degree of bank competition higher.

Credit demand matters

The take-away here is that electoral periods are accompanied with lower access to credit for firms. Our findings accord with the view that greater uncertainty can impair access to credit. Our research provides a major

complement to the literature on elections and banking. Previous works have shown that electoral episodes can be accompanied with a rise in bank lending (e.g. Dinc, 2005; Englmaier and Stowasser, 2017). While this literature focuses on credit supply, we show that, when credit demand is taken into account, elections reduce rather than enhance firm access to credit. We explicate a specific mechanism – *borrower discouragement* – through which the electoral process affects access to credit. We therefore complement the literature identifying the political incentives for banks to increase credit supply by identifying a credit demand mechanism. We do not assert that no manipulation from political authorities takes place to favor bank lending, only that there is evidence that the detrimental impact of the uncertainty channel dominates any manipulation channel for the access to credit. ■

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About the authors

Florian Léon *is research officer at the Foundation for Studies and Research on International Development (FERDI) and a lecturer at the University Clermont-Auvergne (France). He is responsible for the partnership between Ferdi and the Banque de France. His research focuses on financial systems and firm dynamics in developing countries, with a particular interest in Africa. He has published academic papers in several scientific journals, including Economic Development and Cultural Change, Journal of Banking & Finance, Journal of Financial Stability, and Small Business Economics.*

Laurent Weill *is Full Professor of Economics at University of Strasbourg. He is the Director of the research centre in finance (LaRGE) of University of Strasbourg. His research interests are banking, corporate finance, and political economy, with a particular focus on emerging countries (China, Russia, Islamic finance). He has published about 120 papers in journals, among others Journal of Banking and Finance, Journal of Financial Stability, Journal of Comparative Economics, World Development, and Public Choice. He is Visiting Professor in Charles University (Prague), Visiting Professor in Solvay Brussels School of Economics and Management (Université Libre de Bruxelles), and Senior Visiting Fellow in MGIMO University (Moscow). He has been Research Fellow and is visiting researcher at Bank of Finland (BOFIT) regularly since 2008. He has worked on research projects with Banque de France, Czech National Bank, and National Bank of Poland.*

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at