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On the Political Possibility of Separating Banking and the State

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Abstract
The aftermath of the financial crisis proved to be fertile ground to discredit free markets. Further, the crisis was used to justify, expand, and strengthen government regulatory holds over financial services. This study finds that countries that are generally considered to be "free" are also countries that have relatively fewer regulations for their banking systems. The results of this study support the notion that ideology relating to regulation, as measured by indexes of business freedom and personal freedom, are positively associated with financial freedom. Relative freedom of banking from State control is examined across a continuum. Three regressions were performed to observe correlations. Not surprisingly, the extent to which countries embrace financial freedom appears to be inexorably linked to the acceptance of economic and personal freedoms. The results of this study suggest that a decline in financial freedom in the United States is imminent.

JEL codes: G18, G28, L51, P51
Keywords: Banking regulation, Personal freedom, Freedom index, Business freedom, Financial freedom, Regulation of credit, Effects of regulation

I. Introduction

Banking has long been one of the most highly regulated sectors of the American economy. It is also, perhaps surprisingly, more extensively regulated in the United States than in any other comparable developed country. This study examines the pattern of financial freedom across countries, with the objective of determining whether a free-market, or even a less-regulated, banking system is feasible within the United States. Also briefly examined is the political history of U.S. banking regulation, with an eye toward discerning any lessons regarding the future of U.S. banking regulation. In general,

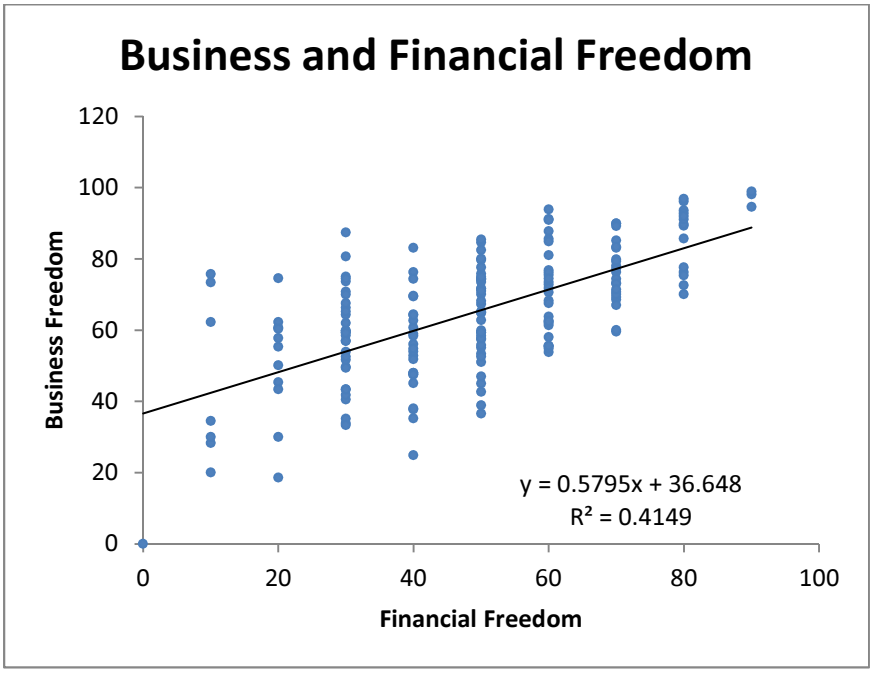
this paper is not about the economic feasibility or desirability of free-market banking.

II. What Causes the Regulation of Banking?

Activities generally recognized as banking developed prior to the regulation of banking. Some aspects of banking created a demand for the regulation of those activities. Classical welfare economics, in the tradition of Pigou, suggests that regulation arises as the result of a market failure, such as the externalities imposed by financial panics or asymmetric information problems between borrowers and lenders. The modern structure of banking regulation, however, with its safety net that creates moral hazard and its restrictions on competition, suggests that correcting market failures has little relation to modern banking regulation. Empirical research on the link between banking regulation and market failure is at best mixed. In their cross-country study, Heinemann and Schuler (2004) "do not find support for a link between stability in the banking system and the supervisory stringency." Heinemann and Schuler do find, however, that more generous deposit insurance schemes are associated with more frequent banking crises, results consistent with those of Barth, Caprio and Levine (2004) as well as Demirgüç-Kunt and Detragiache (2002). Alternative explanations for regulation include: ideology; redistribution of wealth among industry participants, consumers and competitors; and regulation as a source of governmental finance.

One hypothesis is that societies with relatively free banking systems are simply those that embrace free markets in general. That is, a general ideological support for free markets drives the support for less-regulated banking. Simple comparisons do show a high correlation between a measure of general business freedom and financial freedom, as illustrated in Figure 1. Simple comparisons between more open societies (in terms of political freedoms) also display a positive association with financial freedom, but the correlation is weaker.

Figure 1. Business and Financial Freedom



A handful of countries display higher financial freedom than the United States, yet less business freedom (see Figure 2). Countries such as Ireland and Luxembourg experience significantly less business freedom than the United States does—though still more than most countries—yet have higher levels of financial freedom, suggesting that more is at play than a country's overall approach to business regulation. To some degree, banking does appear special, at least in terms of its relationship to government.

Figure 2. Ranking of Financial Freedom, 18 Most Financially Free Countries

Rank	Country	Score
1	Australia	90
2	Denmark	90
3	Hong Kong SAR, China	90
4	Bahrain	80
5	Canada	80
6	Czech Republic	80
7	Estonia	80
8	Finland	80
9	Ireland	80
10	Lithuania	80
11	Luxembourg	80
12	Netherlands	80
13	New Zealand	80
14	Spain	80
15	Sweden	80
16	Switzerland	80
17	United Kingdom	80
18	United States	70

Most countries ranking higher than the United States on financial freedom demonstrate a legal system of English origin, as does the United States. Many are also of Scandinavian legal origin. A small number of countries of German legal origin also rank high on financial freedom, while few countries of the French civil law tradition rank high on financial freedom. These simple rankings support the importance of legal origin in explaining the organization of both law and finance (La Porta et al. 1998). There is the question of whether the various economic freedom indexes, including the financial freedom index, are largely measuring legal origin. By construction, the financial freedom index mirrors a country's reliance on state administrative control versus a heavier reliance on common law.

The regulatory and deregulatory environment for banking in the United States proceeded along a number of dimensions.[1] Perhaps most significant are the thresholds to market entry. Initially, entry into American banking generally required a special charter from a state legislature (White 1982). The "free banking" movement of the early 1800s represented a move to charters being generally available to anyone who could meet the entry qualifications, one of which was often a large purchase of state government debt. Sylla, Legler, and Wallis (1987) document the extensive reliance by state governments on banks as a source of government revenue and deficit financing.

The most common type of entry restriction was state branching restrictions. The eventual removal of these barriers is perhaps the most frequently studied example of banking deregulation (Beck, Levine, and Levkov 2010; Economides, Hubbard, and Palia 1996; Kroszner and Strahan 1999). These studies largely take a private-interest approach to examining reasons for states' deregulating branching when they did. The findings of these studies inform the selection of variables examined here.

American banking deregulation also occurred in relation to the terms of credit. Foremost among these was the removal of price ceilings on credit. These began with the elimination of state-level usury laws and ended most recently with the removal of caps on the allowable rate of interest to be paid on insured deposits, although the FDIC occasionally takes regulatory action against depositories that it believes are paying "excessive" rates. Benmelech and Moskowitz (2010) document the nature of state-level usury laws in nineteenth century America. Their findings suggest that the relative political power of wealthy elites drove these laws. As land holdings largely determined wealth at the time, Benmelech and Moskowitz's results are consistent with the findings of Rajan and Ramcharan (2011) that state-level financial regulations attempted to protect the wealth and position of the landed elite. This paper attempts to add to these findings by looking at the relationship between inequality, both in terms of income and land, and financial regulation. These findings suggest that greater inequality should reduce the level of financial freedom as elites demand increased regulation to protect their status. Alternatively, Peltzman (1980) has argued that greater equality increases the demand for redistribution. To the degree that financial

[1] For a general history of commercial banking in the United States, see Klebaner (1990).

regulation is used to redistribute income, then greater equality (defined by a lower Gini coefficient) would increase the demand for financial regulation in the model of Peltzman.

A critical question regarding deregulation is timing. This study focuses on cross-country differences at one point in time. Financial regulatory changes, however, often exhibit dramatic changes over an abbreviated period of time. One need only think of the New Deal changes, the extensive regulatory changes made in the aftermath of the Savings and Loan Crisis, or the recently enacted Dodd-Frank Act. This history suggests, along the lines of Higgs (1987), that large regulatory changes often follow a crisis. Rodrik (1996) discusses similar crises in the context of structural policy change in emerging economies. The timing of deregulation is beyond the scope of this study. Higgs's (1987) suggestion that ideology has played a prominent role is, however, examined in a cross-country setting. Specific changes in the ideological climate in the United States are discussed separately from the empirical results.

III. Data and Methodology

This study approaches the separation of banking and the State as a continuous measure, in contrast to the binary choice of no government involvement versus government involvement. The measure of government involvement is taken from the Heritage Foundation's Index of Economic Freedom, produced in partnership with the *Wall Street Journal*. A component of the overall index of *economic freedom* consists of a measure of *financial freedom*, also labeled *banking freedom* in earlier data sets. The index of financial freedom ranges from 100 for countries with negligible government interference in financial markets to 0 in countries where private financial institutions are prohibited (see Table 1).

Table 1. Heritage Foundation's Index of Economic Freedom Scores and Implications for Financial Freedom

Score	Implications for Financial Freedom
100	***Negligible government interference***
90	***Minimal government interference*** – Regulation of financial institutions is minimal but may extend beyond enforcing contractual obligations and preventing fraud.
80	***Nominal government interference*** – Government ownership of financial institutions is a small share of overall sector assets. Financial institutions face almost no restrictions on their ability to offer financial services.
70	***Limited government interference*** – Credit allocation is influenced by the government, and private allocation of credit faces almost no restrictions. Government ownership of financial institutions is sizeable. Foreign financial institutions are subject to few restrictions.
60	***Significant government interference*** – The central bank is not fully independent, its supervision and regulation of financial institutions are somewhat burdensome, and its ability to enforce contracts and prevent fraud is insufficient. The government exercises active ownership and control of financial institutions with a significant share of overall sector assets. The ability of financial institutions to offer financial services is subject to some restrictions.
50	***Considerable government interference*** – Credit allocation is significantly influenced by the government, and private allocation of credit faces significant barriers. The ability of financial institutions to offer financial services is subject to significant restrictions. Foreign financial institutions are subject to some restrictions.
40	***Strong government interference*** – The central bank is subject to government influence, its supervision of financial institutions is heavy handed, and its ability to enforce contracts and prevent fraud is weak. The government exercises active ownership and control of financial institutions with a large minority share of overall sector assets.
30	***Extensive government interference*** – Credit allocation is extensively influenced by the government. The government owns or controls a majority of financial institutions or is in a dominant position. Financial institutions are heavily restricted, and bank formation faces significant barriers. Foreign financial institutions are subject to significant restrictions.

20	***Heavy government influence*** – The central bank is not independent, and its supervision of financial institutions is repressive. Foreign institutions are discouraged or highly constrained.
10	***Near repressive*** – Credit allocation is controlled by the government. Bank formation is restricted. Foreign financial institutions are prohibited.
0	***Repressive*** – Supervision and regulation are designed to prevent private financial institutions. Private financial institutions are prohibited.

A similar measure is published by the Fraser Institute, in partnership with the Cato Institute, under the category "regulation of credit" in the annual Economic Freedom of the World index. These two indexes do, however, measure different things. Whereas the Heritage measure reflects primary policy variables under governmental control, the Fraser measure is characterized more by outcomes, as highlighted by the comparison in Heckelman and Stroup (2000). The two measures do yield similar rankings across countries (see De Haan and Sturm 2000), suggesting that this paper's results would not differ significantly if one measure were substituted for the other. These and other variables are defined in Table 2.

Table 2. Variable Definitions

FF	Financial Freedom
BF	Business Freedom
PF	Personal Freedom
G	Government Spending per Capita
GDP	GDP per Capita
AG	Agriculture, valued added as % of GDP
CPI	Annual Percent Increase in Consumer Prices
Urban	Percent of Population in Urban Areas
Top 5 Bank Share	Percent of Deposits held by five largest banks
Land Gini	Gini Coefficient for Land Ownership
Gini	Gini Coefficient for Income

To examine the impact of country-specific economic variables on financial freedom, I performed ordinary least squares regression on the following reduced form equation:

Regression (1) FF = Intercept + BF + PF + IG + G + GNP + AG + CPI + Urban

Banking regulation in the United States has developed as a reaction to the fragility of a fragmented system of small banks. The creation of the Federal Reserve System and the Federal Deposit Insurance Corporation can be viewed as attempts to provide stability to the banking industry. At the time, the industry lacked geographic diversification and access to national capital markets. This was due to the large number of small, local banks, a situation that resulted, in part, from various entry restrictions on banking at the state level, as previously mentioned. To test this hypothesis, I ran a second regression, adding a measure of industry concentration (percent of deposits held by top five banks) to Regression (1). Due to data limitations, Regression (2) is reduced to a sample size of about half that of Regression (1). Laeven (2004) provides evidence, in the context of deposit insurance, that increased strength of smaller banks decreases the likelihood of adopting deposit insurance, which seems to run counter to the U.S. experience (see White 1982).

Regression (2) FF = Intercept + BF + PF + IG + G + GNP + AG + CPI + Urban + Top 5 Bank Share

A handful of studies explain aspects of banking regulation as protecting wealthy elites. Rajan and Ramcharan (2011), for instance, examine the role of large land owners in shaping banking regulation in early twentieth-century America. Benmelech and Moskowitz (2010) similarly examine the interests of wealthy elites in the existence of state usury laws in nineteenth-century America. To test for these effects across countries, Regression (3) adds a Gini coefficient for land ownership. Consistent data on Gini land coefficients are less readily available than other measures used in this study. Accordingly, Regression (3) has a much-reduced sample size.

Regression (2) FF = Intercept + BF + PF + IG + G + GNP + AG + CPI + Urban + Top 5 Bank Share + Land Gini

All variables in Regression (1) are from 2010. Top 5 Bank Share used in Regression (2) is from 1999, and the Gini Land measure in

Regression (3) is from 1990. Appendix A includes full details on data sources. Descriptive statistics are presented in Table 3.

Table 3. Descriptive Statistics

Variable	Observations	Mean	Std. Dev.	Min	Max
Govt. Spending Per Capita	155	16.21	6.11	3.68	37.92
Top 5 Bank Share	70	65.87	22.34	12.00	100.00
GDP Per Capita	186	12,671.18	18,332.39	198.71	103,574.20
Gini	152	40.40	9.25	24.70	65.77
CPI - Inflation	178	4.64	4.06	(2.43)	28.19
AG	147	12.88	13.60	0.00	96.58
Urban	209	57.44	24.36	10.64	100.00
PF	186	3.38	2.15	1.00	7.00
Land Gini	38	0.63	0.16	0.26	0.93
BF	179	64.61	18.48	30.00	99.90
FF	176	48.92	19.17	0.00	90.00

IV. Results

Our regressions, shown in Table 4, support the general notion that ideology, as measured by both business freedom and personal freedom, is positively associated with financial freedom. All else equal, countries that display largely unregulated financial markets are associated with countries where it is relatively easy to do business, as well as those with more personal freedoms and protection of civil liberties.

Table 4. Regressions

	Regression 1		**Regression 2**		**Regression 3**	
Variable	**Coefficient**	**t**	**Coefficient**	**t**	**Coefficient**	**t**
Gini	0.0516695	0.35	0.268891	0.14	0.4312275	0.48
Inflation	-0.9525291	***-2.34***	-0.8664247	-1.40	-0.4847113	-0.30
AG	-0.0417566	-0.38	0.0036846	0.01	-0.7134693	-0.89
Urban	0.0907242	1.16	0.199912	1.59	-0.1454578	-0.40
PF	-1.711026	***-2.49***	-1.233201	-1.29	-0.0471556	-0.01
BF	0.2930864	***2.59***	0.3317667	***2.05***	0.0385813	0.11
G	1.13E-13	0.02	0.1674909	0.46	0.0775784	0.12
GDP	0.0001771	1.49	0.000148	0.86	0.000448	***1.77***
Top 5 Bank Share			0.0572965	0.74	0.1689803	1.39
Land Gini					-25.65205	-1.13
_cons	33.87222	3.00	19.47655	1.12	52.08809	1.52
Number of observations	105		53		17	
R-squared	0.49		0.64		0.92	
Adjusted R-squared	0.45		0.56		0.79	

Significant at 95% confidence

Significant at 90% confidence

Coefficients for income inequality as measured by the Gini coefficient, and for the level of government spending as a percent of GDP, were both insignificant. Percent of GDP from agriculture was also insignificant. The coefficient on rate of inflation was significantly negative, suggesting that higher levels of inflation are associated with lower levels of financial freedom. Higher levels of inflation could also be more likely in an environment of financial repression, suggesting that reduced levels of financial freedom could result from a government's desire to use the financial system as a source of deficit financing.

Regressions (2) and (3), with added measures of banking-sector concentration and a Gini coefficient for land ownership, confirmed the results of Regression (1). Despite the much smaller sample sizes and lack of significance to the added variables, Regressions (2) and (3) displayed considerably higher adjusted R-squared measures. Most

of the observations dropped in regressions (2) and (3) are predominately emerging economies, leaving these regressions as more reflective of OECD countries. In both cases, banking-sector concentration, as measured by the percent of deposits held by the top five banks, is positively related to financial freedom. The Gini coefficient for land ownership is negative, consistent with Rajan and Ramcharan's findings.

V. Discussion

Our most consistent finding is that financial freedom is strongly related to the degree of both business and personal freedom in a country. Countries that are generally "free" are also countries that have relatively freer banking systems. The good news, in terms of a freer banking system, is that the United States has a relatively free economy and open political system. The bad news is that both measures have worsened in recent years. Business freedom in the United States peaked at 93.2 in 2006 and has steadily declined to 90.5 in 2013. Financial freedom has witnessed an even bigger decline over that time, from 90.0 in 2006 to 70.0 in 2013. The aftermath of the financial crisis was used to discredit free markets and to expand government, rather than to address the underlying structural distortions in our financial system. This result owes much to the mistaken belief that the financial crisis was a market failure (Calabria 2009), when it fact it was caused by a variety of policy errors. Continued failures of government, as witnessed by the European sovereign debt crisis, have probably reduced the extent to which the general population is willing to embrace government as the solution to problems in the financial sector. Accordingly, broad deregulation of the U.S. banking system may not have to wait for decades.

The negative association between financial freedom and inflation could pose a significant future concern. While any forecast of future inflation is likely to have a large margin of error, if current Federal Reserve policies eventually induce sizable increases in the rate of inflation, my model suggests this could act as a barrier to deregulation of the U.S. financial system and could even spur additional regulations. On the other hand, the high levels of U.S. inflation in the 1970s induced financial deregulation as existing restrictions became unworkable in the face of record-high interest rates. Given that most financial institutions now face a largely unconstrained cost of funds and flexibility as to loan pricing, the nominal rigidities that contributed to the savings and loan crisis are largely absent today.

Inflationary pressures going forward will likely be the result of fiscal pressures, which would increase the likelihood of financial repression, leading to a reduction in U.S. financial freedom.

A limitation of our analysis is the exclusion of controlling for political institutions. The history of American banking regulation has largely been one of smaller banks using state-level entry restrictions to create local market power. This system was politically sustainable, and perhaps inevitable, in a federal system based upon geographic units with a large degree of political autonomy. In a parliamentary system or a system with a highly centralized government, the relative political influence of large and small banks is likely to be different. This difference might explain the insignificance between industry concentration and financial freedom found here.

There is also a question of causality, to the extent that greater regulation results in higher concentration. Heinemann and Schuler (2004) find limited support for the hypothesis that regulation acts as a barrier to entry. They find, however, that the larger the banking market relative to GDP, the lower the banking market's concentration. These effects are not examined here, but they do suggest that if the U.S. banking market continues to grow—for instance, approaching the relative size-to-GDP ratio found in many EU countries—then concentration may decline. Alternatives to commercial banking could also drive the level of regulation. Large corporate borrowers in the United States are less dependent on bank loans than large corporate borrowers in the EU are. An avenue for further research would be to incorporate measures of the degree of competition between banks and nonbank financial institutions.

While beyond the scope of this study, both the regulation and deregulation of banking within the United States have often occurred in the aftermath of a crisis. Whether the actual legislative responses were appropriate to the causes of each crisis is debatable (Kroszner and Rajan 1994). What seems apparent is the necessity of a crisis to provide the political momentum for broad institutional change. Whether the response to a crisis is regulation or deregulation appears to rely considerably upon the party or persons in power. Kroszner and Strahan (1999) observe, for instance, that the higher the proportion of Democrats in a state's government, the longer it took for that state to deregulate branch banking, all else equal. Despite the 1994 Riegle-Neal Act deregulation of branch banking by the federal government occurring under a Democrat president and Democrat-controlled Congress, Democratic members of the House of

Representatives were less likely to support Riegle-Neal than were Republican members.

Differences can also arise within parties, as with the policy differences between Congressman Henry Steagall and his Senate counterpart Carter Glass. Whereas Steagall favored the creation of the FDIC and the protection of small unit banks, Glass preferred the deregulation of branching restrictions. To some extent, the regulatory landscape of banking in the United States is the result of a negotiation between these two members of Congress. The point is that people and parties do matter. Had Senator Richard Shelby held the chairmanship of the Senate Banking Committee in 2010 rather than Senator Chris Dodd, the response to the financial crisis of 2008 would likely have been very different.

A driver of both regulation and deregulation has often been the advent of new technology. In the case of banking, technologies such as the ATM and the vast increase in computer power likely increased the optimal scale of a single bank. Information and communication technology can also increase the ability of competitors, as was the case when money market mutual funds developed as a less-regulated alternative to bank deposits. Predicting the path of technology is as difficult as doing so for political institutions. New technologies, such a mobile banking and digital currencies, could very well inject instability into the current U.S. regulatory structure. Often, the initial policy response is to extend regulation to these new competitors or to prohibit their use altogether. Whether policymakers in the United States choose to greet financial innovation with barriers or openness is an open question.

VI. Conclusion

The degree of financial market freedom across countries appears to be largely driven by the overall acceptance of economic and personal freedom. Proxies for private interests are largely insignificant, which does not reject the hypothesis that private interests drive financial regulation across countries. Inflation displays a negative relationship with financial freedom. While forecasting social and economic trends is always difficult, the results of this study suggest that those factors driving financial freedom are all headed in a direction that implies declining levels of financial freedom in the United States. Such factors may, however, spur countervailing effects. Passage of the Dodd-Frank Act in the United States was followed the next election cycle with Democrats losing control of the House of

Representatives due to the emergence of the "Tea Party." The results here do suggest that the deregulation of U.S. financial markets will likely occur only in an environment of increasing economic and personal freedom.

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Appendix: Data Sources

Business freedom

The business freedom score for each country is a number between 0 and 100, with 100 equaling the freest business environment. These are from 2010.
http://www.heritage.org/index/business-freedom

Financial freedom

An overall score on a scale of 0 to 100 is given to an economy's financial freedom through deductions from the ideal score of 100. These data are from 2010.
http://www.heritage.org/index/financial-freedom

Political freedom

A score of 1 = Free Society and 10 = Oppressive Regime.
http://www.freedomhouse.org/report-types/freedom-world

General government final consumption expenditure (% of GDP)

This variable ranges from 0 to 100 and is gathered from the World Bank database 2010.
http://databank.worldbank.org/data/home.aspx

GDP per capita growth (annual %)

This variable ranges from 0-100 and is gathered from the World Bank database 2010.
http://databank.worldbank.org/data/home.aspx

GDP per capita (current USD)

GDP per person in the country in current United States dollars from the World Bank database 2010.
http://databank.worldbank.org/data/home.aspx

GINI index

The index ranges from 0 to 100 and the more evenly distributed the income is, the lower the index from the World Bank database 2010. Some of the data were used from the previous years where the Gini coefficient was measured.
http://databank.worldbank.org/data/home.aspx

Inflation, consumer prices (annual %)
Comparing prices of a bundle of goods within a country from the World Bank database 2010.
http://databank.worldbank.org/data/home.aspx

General government final consumption expenditure (current USD)
Total amount of government spending in 2010 by country.
http://databank.worldbank.org/data/home.aspx

Agriculture, value added (% of GDP)
Value added from agriculture as a percent of GDP from 2010.
http://databank.worldbank.org/data/home.aspx

Urban population (% of total)
The percent of population in urban areas in 2010.
http://databank.worldbank.org/data/home.aspx

GNI per capita, Atlas method (current USD)
Gross national income per person in current United States dollars in 2010.
http://databank.worldbank.org/data/home.aspx

Gini's Index of Concentration
Index of land concentration within the country from the 1990 census. The lower the index, the lower the amount of concentration; the higher the index, the higher the amount of concentration.
http://www.fao.org/economic/the-statistics-division-ess/world-census-of-agriculture/additional-international-comparison-tables-including-gini-coefficients/other-international-comparison-tables-of-agricultural-census-data-explanatory-notes-and-comments/ar/

Top 5 bank share
This shows the concentration of the top five banks within the country. Source: Barth, Caprio, and Levine (2004).