ABSTRACT

This dissertation examines the effect of the legal environment on access to several types of external finance, and on the decision to invest, for the 3 countries that make up the East African Community (EAC). The results suggest that well defined creditor rights are positively correlated with access to bank loans. Strong creditor rights places pressure on firms to keep good quality financial records. More lending takes place in this environment. A good quality legal system also improves access to non-bank finance, namely trade credit and leasing finance. The analysis demonstrates that collateral in the form of machinery and equipment improves access to bank finance. Collateral appears to be of greater importance when legal enforcement costs are relatively low and information asymmetry is more acute. The results also show that the property rights environment is important for investment. However, the protection of property rights has a more meaningful effect on investment in an environment where the costs of corruption are lower and courts are more efficient. Access to bank finance has a significant positive effect on investment. Thus, a legal system that improves the flow of funds from banks to firms promotes growth enhancing activities. Internal sources of finance are also found to be important for investment. It is recommended that strong emphasis is placed on improving the laws protecting the rights of creditors over property pledged as collateral and over information they can obtain from debtors. Debtor rights over assets in their possession should also be strengthened.