

The Power of Governance: Do Democracy and Corruption Matter for Stock Market Development in Emerging Markets?

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Abstract

This study examines how the Democracy Index and Corruption Perceptions Index, affects stock market capitalization in 24 emerging countries from 2006 to 2022. Using panel data regression, it investigates both the individual and combined impacts of democracy and corruption on market capitalization. The findings suggest that democracy is positively associated with stock market capitalization; however, this relationship is only weakly significant at the 10% level. In contrast, corruption does not exhibit a statistically significant direct effect. When considered jointly, democracy remains marginally significant, while corruption and its interaction with democracy are not statistically significant. Additionally, in high-income emerging markets, democracy play a crucial role in shaping market capitalization, whereas in other markets, neither exerts a meaningful effect. These results underscore the importance of democracy in driving financial market growth, particularly in wealthier economies.

Keywords: Stock market development, Democracy, Corruption, Emerging economies, Market capitalization

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Introduction

The relationship between institutional quality and stock market development is a crucial topic in finance and economics. Democracy, with its emphasis on transparency, accountability, and investor confidence, is often seen as a driver of market growth. In contrast, corruption is widely regarded as an obstacle that distorts resource allocation and weakens trust in financial systems. However, the interaction between democracy, corruption, and stock market development is complex and requires further examination.

A country's political system significantly influences its economic stability, affecting capital flows, investment risks, and market size. Political instability, weak institutions, and corruption scandals have historically led to financial crises, as seen in the 1997 Asian Financial Crisis and Brazil's 2016 corruption scandal. More recently, geopolitical instability from the Russia-Ukraine conflict (2022) has underscored how governance quality directly impacts investor confidence and stock market performance.

Institutional factors such as democracy and corruption play a key role in shaping financial markets. Democratic institutions contribute to financial market development through several institutional channels. Strong democratic governance improves the rule of law, strengthens investor protection, and enhances transparency in financial reporting. These institutional improvements create a more stable legal environment that protects investor rights and increases confidence in financial markets (La Porta et al., 1997). As investors become more confident that their rights are protected and financial contracts can be enforced, they are more willing to supply capital through equity and debt markets. Consequently, firms gain greater access to external finance, leading to more listed companies, increased IPO activity, and higher stock market capitalization. Conversely, corruption imposes hidden costs on businesses, increasing economic inefficiencies (Doh et al., 2003). While some research suggests corruption may help navigate bureaucratic inefficiencies in the short term, it ultimately undermines market integrity and long-term economic stability.

Previous studies have analyzed political risks and stock market performance, showing that democratization positively impacts stock market returns (Lehkonen & Heimonen, 2015). However, limited research explores how democracy and corruption interact to influence financial markets, particularly across countries with different income levels. Since democracy fosters transparency and investor protection, while corruption can erode institutional trust and distort market operations, their combined effects may either reinforce or offset each other.

Therefore, examining both factors together provides a more accurate and comprehensive understanding of their influence on stock market development. This study aims to fill that gap by examining how these two institutional factors jointly shape stock market development in 24 emerging markets from 2006 to 2022. Using panel data regression on 373 country-year observations, the analysis investigates the impact of democracy and corruption on stock market development, measured by market capitalization as a percentage of GDP, the Democracy Index, published by the Economist Intelligence Unit, and the Corruption Perceptions Index, provided by Transparency International. To provide a deeper analysis, the study classifies emerging markets into two groups based on GDP per capita, high-income and low-income countries, to assess whether these two institutional factors have a differential impact depending on economic development levels.

Literature Review

Stock market development is essential for economic growth, serving as a key indicator of financial health and investment climate. A well-functioning stock market facilitates capital raising, investment diversification, and economic stability. Demirgüç-Kunt and Levine (1996) found stock market capitalization to be a reliable measure of financial development, while Garcia and Liu (1999) emphasized its role in tracking financial growth. Given its significance, understanding factors influencing stock market development is particularly important for emerging economies.

Among these factors, democracy plays a crucial role by fostering transparency, investor protection, and political stability. Lei and Wisniewski (2018) argue that democratic environments promote long-term investment. In democratic systems, policies and regulations are generally more predictable, and property rights tend to be better protected. This reduces political and institutional uncertainty for investors, making them more willing to commit capital for long-term investments. While Biglaiser et al. (2008) highlight democracy's role in attracting capital, especially in developing nations. Lehtonen and Heimonen (2015) found that transitioning democracies experience the greatest stock market growth, as improving governance boosts investor confidence. As investor confidence increases, both domestic and foreign investors are more likely to participate in financial markets. Firms therefore gain greater access to external financing through equity issuance and stock market participation. Over time, this process contributes to financial market development by increasing stock market liquidity,

encouraging more firms to list on the stock exchange, and expanding overall market capitalization.

Conversely, corruption hinders stock market development by increasing transaction costs, fostering uncertainty, and weakening institutional trust. Doh et al. (2003) highlight corruption's direct and indirect costs, reducing productivity and discouraging investment. Studies across Greece, Latin America, and Africa show that corruption stifles firm growth and market efficiency (Athanasouli et al., 2012; Faruq et al., 2013; Gaviria, 2002; McArthur & Teal, 2002). Diamonte et al. (1996) found that political instability, including corruption, suppresses market returns, while Lee and Ng (2002) linked corruption to declining firm value and investor confidence.

The impact of corruption varies across income levels. Chowdhury et al. (2023) analyzed 87 economies and found that corruption significantly reduces stock market capitalization in high-income countries, while its effect in low-income economies is minimal. This suggests that macroeconomic fundamentals play a more dominant role in shaping financial markets in less developed regions.

Additionally, good governance enhances information flow within financial markets, further strengthening investor confidence and market efficiency. Dumitrescu and Zakriya (2022) found that well-governed financial systems facilitate transparent information dissemination, reducing uncertainty and enabling more accurate asset pricing. Similarly, Aramonte and Packer (2022) highlight that information governance mechanisms mitigate conflicts of interest, ensuring that market participants receive reliable financial data, which is essential for capital allocation. Mehran and Mollineaux (2012) further emphasize that regulatory disclosure requirements in well-governed economies enhance market discipline, allowing investors to assess risks effectively and promoting financial stability. These findings suggest that good governance plays a crucial role in improving financial markets by fostering transparency, reducing information asymmetry, and reinforcing institutional trust, ultimately supporting sustainable economic growth.

Methodology

Research Question

Emerging markets offer high growth potential but also greater risks due to political uncertainty. Governance structures, election fairness, transparency, and institutional strength,

play a crucial role in attracting investment and determining market stability. Understanding the interplay between political factors and stock market development is essential for investors and policymakers aiming to navigate economic volatility and foster financial growth. This study contributes valuable insights into how governance quality influences stock markets, highlighting the need for strong institutions in emerging economies.

Empirical Model

This study adopts a quantitative research approach, utilizing panel data regression analysis to capture both cross-sectional and time-series variations. The analysis examines the impact of democracy on stock market development, the effect of corruption on stock market development, and the combined influence of the Democracy Index and the Corruption Perceptions Index on market capitalization. To achieve this, the following panel data regression model is specified.

$$\text{Model (1)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Dem}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

$$\text{Model (2)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Cor}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

$$\text{Model (3)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Dem}_{it} + \beta_2\text{Cor}_{it} + \beta_3\text{DemxCor}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

To examine whether democracy and corruption have a greater impact on market capitalization in high-income countries compared to low- and middle-income countries, this study divides the data into two groups based on income levels. The classification is determined according to the World Bank's income classification. The following panel data regression model is then used to analyze these differences.

Low- and Middle-income data and High-income data

$$\text{Model (4), (7)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Dem}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

$$\text{Model (5), (8)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Cor}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

$$\text{Model (6), (9)} : \ln\text{MCap}_{it} = \beta_0 + \beta_1\text{Dem}_{it} + \beta_2\text{Cor}_{it} + \sum_{j=1}^n X_{jit} + \lambda_{it} + \varepsilon_{it}$$

Where $\ln\text{MCap}_{it}$ represents the natural logarithm of stock market capitalization (normalized by GDP) for country i at time t . Dem_{it} represents the Democracy Index score. Cor_{it} represents the Corruption Perceptions Index score. DemxCor_{it} represents the interaction term between the Democracy Index (Dem) and the Corruption Perceptions Index (Cor). X_{jit} representing Control variables such as income levels, investment activity, banking sector development, and macroeconomic stability. λ_{it} represents the country-specific time-invariant effect. ε_{it} represents the stochastic term (Error Term).

The researchers conducted diagnostic tests to ensure the reliability of the analysis. First, the Breusch-Pagan test was performed to assess the presence of heteroskedasticity. The findings revealed that heteroskedasticity was present in most models. To address this issue and obtain robust and reliable standard errors, cluster-robust standard errors were applied throughout the analysis. Additionally, the Variance Inflation Factor (VIF) was used to examine potential multicollinearity among independent variables. The results showed that all variables across 10 models had VIF values below 5, confirming that multicollinearity was not a concern in the analysis.

Data and variables

In this study, the researcher analyze equity market performance across 24 emerging nations as classified by MSCI spanning the period from 2006 to 2022, including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. However, due to significant data unavailability for Kuwait, Qatar, and Taiwan, these countries were excluded from the analysis. Instead, we included Morocco, Pakistan, and Russia, which have classified as emerging markets for most of the study period. Their classification has changed in recent years. Morocco was reclassified by MSCI from emerging market status to frontier market status in 2013, while Pakistan was downgraded from emerging market to frontier market in 2021. Russia, on the other hand, was removed from the MSCI Emerging Markets Index in 2022 following geopolitical and market accessibility issues. Despite these reclassifications, these countries are retained in the sample because they were part of the emerging market group during most of the study period.

Dependent Variable

We measure stock market development using the natural logarithm of stock market capitalization as a percentage of GDP ($\ln\text{MCap}$). This variable is computed by multiplying the share prices of listed domestic companies (in USD) by the number of outstanding shares and dividing the result by the country's GDP (also in USD). The value is expressed as a percentage rather than in currency units. Investment funds, unit trusts, and companies whose primary purpose is to hold shares of other listed firms are excluded. The data, sourced from the World Bank's World Development Indicators (WDI) database, represents end-of-year values.

Independent Variable

This study focuses on two key independent variables, the Democracy Index (Dem) and the Corruption Perceptions Index (Cor), both of which serve as proxies for institutional quality in emerging markets.

The Democracy Index, published by the Economist Intelligence Unit (EIU), was published every two years before 2010 and has been reported annually since then. The index incorporates five interrelated categories, electoral process and pluralism, civil liberties, government functioning, political participation, and political culture. To address the issue that the Democracy Index was published biennially before 2010, we apply a linear interpolation technique by taking the average of the Democracy Index values from the preceding and following years.

Building on prior research (Chowdhury et al., 2023), the Corruption Perceptions Index (CPI) serves as a measure of corruption control, where higher CPI values indicate lower levels of corruption. Transparency International (TI) were reported CPI scores on a scale of 0 to 10 from 1995 to 2011. However, from 2012 to 2022, TI adjusted the scale to range from 0 to 100. To ensure consistency across years, this study applies a conversion by multiplying scores from 2006 to 2011 by 10, aligning them with the later scale. Under this system, a CPI score of 0 represents a highly corrupt environment, while a score of 100 indicates a very low level of corruption. As noted by Papyrakis et al. (2019), the CPI is a widely recognized and frequently used indicator for assessing cross-country variations in corruption.

Control Variable

To account for macroeconomic factors influencing stock market development, this study incorporates annual data on income levels, investment activity, banking sector development, and macroeconomic stability. These data are sourced from the World Development Indicators (WDI) database. Income levels are represented by GDP per capita ($\ln GDP$), while investment is assessed through gross fixed capital formation as a percentage of GDP ($\ln Inv$). The development of the banking sector is captured by the proportion of domestic credit extended to the private sector by banks relative to GDP. Additionally ($\ln Cre$), inflation, measured using the consumer price index ($\ln Inf$), is included as a control variable, often interpreted as an indicator of macroeconomic stability, all logged.

Results and Discussion

Preliminary Data Analysis

Figure 1 illustrates the evolution of stock market development in emerging market economies over time. The figure presents the average stock market capitalization as a percentage of GDP, distinguishing between countries with GDP per capita below the threshold of 11,513.23 and those above it for each year. The graph indicates that, consistently across all years, the average stock market capitalization in higher-income emerging markets is notably lower than that of lower-income emerging markets. This pattern persists throughout the entire study period, highlighting a significant structural difference between the two groups. The 2008 financial crisis led to a sharp decline in stock market capitalization, which fell more rapidly than GDP per capita. This divergence reflects a significant contraction in financial markets relative to the overall economy during that period, as observed in the graph. In contrast, during the COVID-19 pandemic (2019–2022), both stock market capitalization and GDP per capita declined, but at a relatively similar rate. As a result, the ratio between the two metrics remained more stable, and the overall value on the graph appears less volatile compared to the 2008 crisis. This comparison suggests that while both events negatively impacted the economy, their effects on financial markets and real economic indicators differed in magnitude and timing.

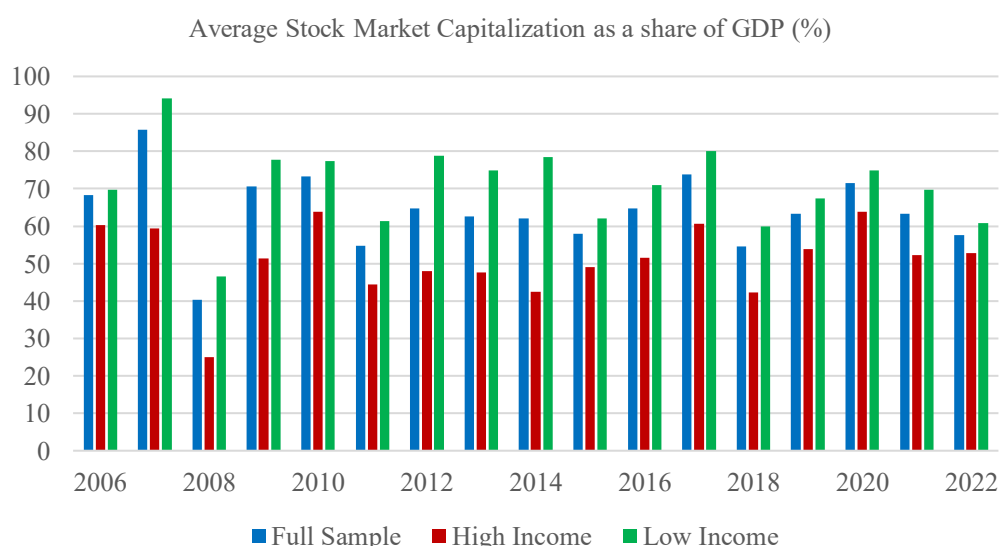


Figure 1 The Evolution of Average Stock Market Capitalization as a Share of GDP Over Time

Descriptive Statistical Analysis

Table 1 presents the descriptive statistics, providing insights into the characteristics of the underlying data. The natural logarithm of stock market capitalization as a percentage of GDP (lnMCap) has a mean value of 3.92, which corresponds to approximately 50.35% of GDP, reflecting a typical feature of emerging markets. The Democracy Index (Dem) has an average of 5.779, indicating a moderate level of democracy, neither particularly high nor low, and suggesting that democratic governance varies widely across the sample of emerging countries. The Corruption Perceptions Index (Cor) has a mean of 42.24 and a median of 39.00, indicating that corruption levels are relatively high among these emerging markets.

Table 2, examining the relationships between the variables in the dataset. The dependent variable lnMCap has a positive correlation with several key variables, including Dem (0.228), Cor (0.182), lnInv (0.221), and lnCre (0.438). lnCre has the highest correlation with lnMCap, indicating that financial sector development plays a crucial role in market capitalization. On the other hand, lnMCap has a negative correlation with lnGDP (-0.054) and lnInfl (-0.154). The weak correlation with lnGDP suggests that stock market capitalization is not strongly linked to a country's GDP per capita. The negative correlation with lnInfl indicates that higher inflation levels tend to be associated with lower market capitalization.

Table 1 Summary Statistics

Variables	N	Mean	Median	S.D.	Min	Max
lnMCap	382	3.92	3.87	0.75	2.04	5.80
Dem	408	5.78	6.49	1.88	1.71	8.28
Cor	408	42.24	39.00	11.75	21.00	73.00
lnGDP	408	8.98	9.11	0.92	6.69	10.89
lnInv	406	3.12	3.13	0.28	2.37	3.80
lnCre	401	3.97	3.95	0.57	2.63	5.23
lnInfl	407	1.91	2.00	0.96	-1.49	4.97

Table 2 Pearson's Correlation Coefficients

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1) lnMCap	1.00						
(2) Dem	0.23	1.00					
(3) Cor	0.18	0.20	1.000				
(4) lnGDP	-0.05	0.08	0.686	1.000			
(5) lnInv	0.22	-0.05	0.049	-0.039	1.000		
(6) lnCre	0.44	0.11	0.458	0.433	0.282	1.000	
(7) lnInfl	-0.15	-0.08	-0.358	-0.359	0.025	-0.431	1.000

Inferential Statistical Analysis

Full Sample

Table 3 shows the results of the panel data regression analysis. Column 1 presents the results for Model 1, which examines how democracy affects stock market development. Column 2 shows the results for Model 2, which focuses on the impact of corruption. Columns 3 report the results for Models 3, which analyze both democracy and corruption together to see their individual and combined effects on market capitalization.

The results show that in Model 1, the Democracy Index (Dem) has a positive relationship with market capitalization (lnMCap), with a coefficient of 0.08, significant at the 10% level. This suggests that higher democracy levels are linked to increased market capitalization, but the weak significance level indicates that the effect is not very strong.

In Model 2, the Corruption Perceptions Index (Cor) has a coefficient of 0.00, but it is not statistically significant. This means that corruption alone does not have a clear impact on market capitalization.

In Model 3, where both democracy and corruption are considered together, the Democracy Index (Dem) still has a positive effect on market capitalization, with a coefficient of 0.08, significant at the 10% level. However, the Corruption Perceptions Index (Cor) remains statistically insignificant. The interaction term (DemxCor) has a coefficient of -0.00 but is not statistically significant. This suggests that the combined effect of democracy and corruption does not create a meaningful impact on market capitalization.

Table 3 The Impact of Democracy and Corruption on Stock Market Capitalization

Variables	Model 1		Model 2		Model 3	
	Est.	p	Est.	p	Est.	p
Dem	0.08*	0.080			0.08*	0.092
	(0.05)				(0.05)	
Cor			0.00	0.758	0.00	0.686
			(0.00)		(0.00)	
DemxCor					-0.00	0.853
					(0.00)	
lnGDP	-0.26	0.114	-0.30	0.165	-0.27	0.112
	(0.16)		(0.22)		(0.17)	
lnInv	0.80***	0.008	0.93***	0.003	0.81***	0.009
	(0.30)		(0.32)		(0.31)	
lnCre	0.16	0.429	0.06	0.801	0.16	0.456
	(0.20)		(0.22)		(0.21)	
lnInfl	-0.10***	0.000	-0.10***	0.000	-0.10***	0.001
	(0.03)		(0.03)		(0.03)	
Observation	373		373		373	
F-Statistic	12.31	0.000	12.49	0.000	12.71	0.000
R-Squared	0.16		0.15		0.16	
Adjusted R-Squared	0.14		0.08		0.14	
Breusch-Pagan test	62.86	0.000	50.94	0.000	59.06	0.000
Hausman Test	8.76	0.119	11.83	0.037	9.16	0.242

Low and Middle income

Table 4 presents the results of Models 4, 5, and 6, which analyze the effects of democracy, corruption, and their combined influence on market capitalization in low-income countries. In Models 4 and 5, the coefficients for the Democracy Index (Dem) and the Corruption Perceptions Index (Cor) are 0.06 and -0.01, respectively, but neither is statistically significant. This suggests that democracy and corruption alone do not have a strong direct impact on market capitalization in these economies. Similarly, in Model 6, where both variables are combined, the results remain statistically insignificant, indicating that their combined effect does not significantly influence market capitalization in low-income countries.

Table 4 The Impact of Dem and Cor Across Low-Income Countries

Variables	Model 4		Model 5		Model 6	
	Est.	p	Est.	p	Est.	p
Dem	0.06 (0.08)	0.406			0.07 (0.08)	0.385
Cor			-0.01 (0.01)	0.498	-0.01 (0.01)	0.417
lnGDP	-0.34 (0.26)	0.185	-0.30 (0.28)	0.279	-0.30 (0.27)	0.266
lnInv	0.65** (0.30)	0.030	0.76** (0.37)	0.041	0.66** (0.29)	0.024
lnCre	0.22 (0.30)	0.454	0.17 (0.29)	0.554	0.23 (0.30)	0.440
lnInfl	-0.18*** (0.04)	0.000	-0.18*** (0.05)	0.000	-0.18*** (0.05)	0.000
Observation	266		266		266	
F-Statistic	10.34	0.000	10.05	0.000	8.74	0.000
R-Squared	0.18		0.17		0.18	
Adjusted R-Squared	0.10		0.09		0.10	
Breusch-Pagan test	52.37	0.000	57.31	0.000	53.65	0.000
Hausman Test	12.90	0.024	14.85	0.011	14.08	0.029

High-income

Table 2 presents the results of Models 7, 8, and 9, which examine the impact of democracy and corruption on market capitalization in high-income countries.

In Model 7, the Democracy Index (Dem) has a coefficient of 0.55 and is statistically significant at the 1% level, showing a strong positive relationship between democracy and market capitalization. This suggests that democratic institutions play a crucial role in financial market development in high-income economies.

In Model 8, the Corruption Perceptions Index (Cor) has a coefficient of 0.01, not statistically significant, indicating that Corruption does not significantly influence market capitalization.

In Model 9, where both democracy and corruption are considered together, Dem remains highly significant, coefficient of 0.53 at the 1% level, reinforcing its positive impact on market capitalization. Cor also remains not significant, coefficient of 0.01. These results suggest that in high-income economies, strong democratic institutions enhance stock market development.

Table 5 The Impact of Dem and Cor Across High-Income Countries

Variables	Model 7		Model 8		Model 9	
	Est.	p	Est.	p	Est.	p
Dem	0.55*** (0.16)	0.001			0.53*** (0.17)	0.003
Cor			0.01 (0.01)	0.171	0.00 (0.01)	0.483
lnGDP	-0.22 (0.28)	0.437	-0.34 (0.33)	0.312	-0.24 (0.26)	0.370
lnInv	0.70*** (0.14)	0.000	1.03*** (0.28)	0.000	0.71*** (0.14)	0.000
lnCre	-0.30* (0.18)	0.088	-0.12 (0.21)	0.590	-0.30* (0.17)	0.086
lnInfl	-0.08* (0.04)	0.079	-0.04 (0.04)	0.378	-0.07 (0.04)	0.104
Observation	107		107		107	
F-Statistic	9.01	0.000	5.37	0.000	7.53	0.000
R-Squared	0.33		0.22		0.33	
Adjusted R-Squared	0.23		0.12		0.23	
Breusch-Pagan test	11.04	0.051	14.80	0.011	15.00	0.020
Hausman Test	11.05	0.050	6.21	0.286	13.85	0.031

Effect of Banking Sector Development

Model 10 examines how banking sector development influences the relationship between democracy and stock market development. To do this, an interaction term (DemxlnCre) is included in the analysis. The results, shown in Table 6, focus on emerging economies and reveal that the coefficient for this interaction term is negative and statistically

significant at the 1% level. This means that as domestic credit to the private sector increases, the positive impact of democracy on stock market development weakens. In other words, in economies where banks provide more credit to businesses, democracy has a smaller effect on market growth. From a researcher's perspective, this can be explained by changes in firms' capital structure, when businesses have greater access to bank financing, they are less reliant on raising capital through the stock market. As a result, the importance of stock market development diminishes in economies with a more active and accessible banking sector.

Table 6 The Impact of Democracy and Corruption Across High-Income Countries

Variables	Model 10	
	Est.	p
lnMCap _{t-1}		
Dem	1.09*** (0.30)	0.000
DemxlnCre	-0.24*** (0.07)	0.000
lnGDP	-0.26* (0.15)	0.096
lnInv	0.65** (0.29)	0.026
lnCre	1.50*** (0.47)	0.002
lnInfl	-0.08*** (0.03)	0.003
Observation	373	
F-Statistic	17.45	0.000
R-Squared	0.23	
Adjusted R-Squared	0.17	
Breusch-Pagan test	66.80	0.000
Hausman Test	15.69	0.016

Conclusion and Discussion

The findings provide limited and conditional evidence regarding the role of democracy in stock market development. While democracy is found to be positively associated with stock market capitalization, the relationship is relatively weak and not uniformly observed across all countries. The effect appears to depend critically on country-specific conditions, particularly income level.

When disaggregating the sample, the results show that income level is a key conditioning factor. In high-income emerging markets, democracy exhibits a statistically significant positive association with stock market capitalization, suggesting that stronger democratic governance may support financial market development in these contexts. This finding is consistent with prior studies such as Lei and Wisniewski (2018), Biglaiser et al. (2008), and Lehkonen and Heimonen (2015), which highlight the role of democratic institutions in promoting investment, participation, and market confidence.

In contrast, for low- and middle-income emerging economies, no statistically meaningful relationship is found between democracy and stock market capitalization. This suggests that improvements in democratic governance alone may not be sufficient to stimulate stock market development in these countries, where structural and economic constraints may play a more dominant role.

Similarly, corruption does not exhibit a statistically significant direct effect on stock market capitalization across the sample. Its influence appears to be context-dependent, potentially interacting with broader economic and institutional conditions. This is consistent with Chowdhury et al. (2023), who find that the effect of corruption on financial development varies across income groups and levels of economic development.

Taken together, these findings highlight that the relationship between institutional factors, specifically democracy and corruption, and stock market development is conditional rather than universal. The evidence suggests that institutional quality does not exert a uniform effect across all emerging markets, but instead operates differently depending on the level of economic development.

Accordingly, the implications of this study should be interpreted with caution. For policymakers, the results indicate that strengthening democratic governance and reducing corruption may be more effective in promoting stock market development in higher-income emerging markets, while in lower-income contexts, broader structural reforms may be

necessary. For investors, the findings emphasize the importance of considering income level and institutional context jointly, rather than relying on generalized assumptions about the role of democracy or corruption in shaping market outcomes.

Limitations of the study

This study, while offering valuable insights into the relationship between democracy, corruption and stock market development in emerging markets, has several limitations that should be acknowledged.

First, the analysis relies on secondary data sources, which may contain measurement inconsistencies or missing values across countries and years. Such data quality issues could potentially affect the precision of the estimates. Both the Democracy Index and Corruption Perceptions Index are obtained from single data providers. This reliance on one source for each indicator may limit the robustness of the findings, as alternative measures might capture different dimensions of democracy and corruption.

Second, although the study employed several diagnostic tests to ensure model validity, potential endogeneity between democracy, corruption, and stock market development may still exist in some models. The presence of two-way causality could bias the estimated relationships and limit the ability to draw strong causal inferences.

Finally, the model may omit certain variables that also influence stock market development, such as financial literacy, technological innovation, or investor protection measures. Future research could extend this work by incorporating these additional factors and employing advanced econometric methods, such as dynamic panel estimators, to better address endogeneity concerns.

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