Financial Development and Human Capital: How close is the link?

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Financial development takes place when the financial intermediaries and markets are able to allocate resources and perform other necessary functions by overcoming information costs, transaction costs and enforcement costs (Demirguc-Kunt & Levine (2008). Theoretically, the contribution of finance to economic growth has been firmly established (King & Levine 1993; Levine 1997; Demirguc-Kunt & Levine 2008; Greenwood & Jovanovic 1990; Bencivenga & Smith 1991). The determinants of financial development, as noted by various studies, are technological innovations, telecommunications, legal environment and political stability (Levine 1997, Outreville 1999). The contribution of human capital to financial development and the relationship between the two has not been much examined. Some studies have examined the relationship between the interaction of finance and human capital at the cross country level. However, cross-country regressions can be fragile, encounter problems of simultaneity (dependent and independent variables are jointly determined), multicollinearity; and degrees of freedom (Levine 1992; Mankiw 1995). Our study, in contrast, in a panel dataset for 23 states of India using Ordinary Least Squares (OLS) method examines the relationship between financial development and human capital for the period 1999-2000 to 2007-08.

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