

The links between finance and inequality: channels and evidence

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Abstract

Much attention has recently been given to whether market reforms reduce or increase inequality. Inequality often reflects unequal access to productive opportunities and recent evidence has highlighted the presence of onerous barriers to entry, especially in developing countries. This paper focuses on the relationships between inequality and finance. In principle, a better financial system can help overcome barriers, and thereby increase economic growth and reduce inequality. Indeed, a more developed, that is deeper, financial sector has been shown to aid economic growth. Financial reform will only reduce inequality, however, if it improves access for more individuals with growth opportunities. Reforms thus need to broaden, not just deepen financial systems.

At the same, as recent theoretical and empirical work has shown, ex ante inequality can hinder welfare enhancing reforms. Concentrated economic and political powers will likely block financial (and other) reforms, or manipulate their design and/or implementation, so that the benefits reach fewer individuals. Also, by design or implementation, financial reforms can lead risks to be allocated unfairly and costs to be socialized, especially around financial crises, further worsening inequality. Furthermore, reforms that do not provide gains for many may be followed by a political backlash that may make even valuable financial sector reforms not sustainable.

We analyze these various channels from inequality to financial sector reform and provide (case) evidence on them. We then address the question, how, given initial wealth and power distributions, financial (and other) reforms could be designed such as to improve access and prevent perverse outcomes. We conclude, among others, that more gradual reform allowing the buildup of various types of oversight institutions is necessary for countries with high inequality.

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Executive summary

- Inequality of income (and wealth) reflects barriers for some to opportunities to produce, with loss of overall economic growth. Broadening access to productive opportunities depends in part on overcoming a variety of entry barriers, among which access to finance. Financial sector reform has been identified as a solution to this problem, although the emphasis has more been on promoting financial depth than on financial breadth.
- Broad financial access matters in several ways:
 - Financing is needed for investment of new entrants and expansions; and
 - Financing can overcome various barriers, since money is fungible.
- Financial reform—to the extent that it enhances broadening—is therefore important for enhancing equality of opportunities and growth. Yet the evidence of improved access following financial reform and liberalization is discouraging in developing countries. Often, financial development has not followed and when financial development has taken place, it has favored deeper over broader systems and inequality often rises.
- Although it is perhaps inevitable that inequality increases at first as a result of reforms and liberalization, since these processes may enhance already defined comparative advantages, too often gains appear to largely be reaped by insiders, even if it improved average income or welfare (as has been shown).
- This may be because often a top-down approach to deregulation is followed, with an emphasis on formal institutions typical of current developed economies, such as stock markets. Such top-down reforms, however, can favor more established producers and individuals, especially in unequal societies, without improving broad access to funding, and in some cases worsening it.
- While, and looking back, some of these outcomes arose because “mistakes” were made in many reforms, part of the often poor design and/or implementation of financial reform were deliberate to ensure that the gains accrued to only a few. There is also evidence, especially from financial crises, that many risks were distorted and that costs associated with reforms were widely socialized at the

benefit of a few insiders. Besides skewing the reforms, since the financial sector is easier to manipulate than other sectors, control over the financial system has been convenient to target benefits of reforms more generally.

- We argue here that the lack of success of financial reform may be the consequence itself of a highly skewed distribution of wealth and power. Inequality itself can be a hinder to productive financial reform and financial development when powerful interests block or manipulate reforms so as to capture the benefits and avoid the costs. Or, if more financial development just leads to the expansion of stronger economic entities at the cost of weaker ones, in part as costs become socialized, financial reform can actually worsen the distribution of income and wealth and may, over time, create a strong backlash and make financial reforms politically sustainable.
- The question then is, given certain wealth and power distributions, how to design financial reforms such as to assure broad access and prevent perverse outcomes? By what mechanisms can one ensure that financial reforms contribute to a subsequent diffusion of welfare? How can financial reform be encouraged and be designed to ensure a broadening of the productive basis of developing countries which is politically sustainable?
- This involves several questions on the design and implementation of financial reform: what is the optimal sequencing of reform, what are the necessary improvements/corrections to the institutional environment; which institutional changes must precede liberalization; what type of complementary reforms are necessary; and how can one ensure proper scrutiny on the governance of reforms?
- We address these questions conceptually and using (case) examples. We argue in particular that the preferred model in countries with high inequality will be more gradual reform allowing the buildup of oversight institutions, both of a financial and political nature. Quantity measures and segmentation of parts of the financial system can furthermore be useful to prevent perverse outcomes. Other types of economic reform, policies that directly affect wealth distribution, like privatization, and educational efforts can usefully support financial sector reform.

The links between finance and inequality: channels and evidence

The outline of the paper is as follows. Section 1 reviews the evidence on the links between finance and inequality. Section 2 develops the arguments on the links from inequality to financial sector development. Section 3 provides suggestions for reform policies to address the reverse links. Section 4 concludes.

1. The links between finance and inequality: the channels and evidence.

The importance of entrepreneurial activity to growth. Entrepreneurial activity is an important determinant of economic success of countries. Entrepreneurs are, by definition, small firms, and their growth is thus a good indication of the degree of entrepreneurial activity. Johnson, McMillan and Woodruff (2003) document the critical role played by new entrepreneurs in determining the relative economic success across a sample of transition countries. Demirguc-Kunt and Maximovic (2003) document cross-country evidence that a large formal small and medium enterprise (SME) sector is a characteristic of successful economies. This is not because SMEs necessarily drive growth; they show that the overall competitiveness of the business environment fosters growth, development and poverty alleviation. Rather, the presence of SMEs in the *formal sector* may be an indicator of moderate entry barriers and the lack of barriers drive successful economies.¹

The barriers to entrepreneurial activity. Indeed, and particularly in developing countries, entrepreneurs face large barriers to start their businesses, and often onerous rules and costs to conduct their activities in the formal sector. Examples of formal obstacles are the number of necessary licenses, the number of different agencies handling such licenses, high fees and taxes; informal barriers include barriers to financing, frequent inspections aimed largely at extracting bribes, and biases in regulatory and contractual enforcement

¹ Many countries have specific programs aimed at fostering entrepreneurial and SMEs growth, including through venture capital and credit lines, suggesting that public policy considers SME and entrepreneurship important (even though the instruments used may not be the most efficient and be misused).

in favor of established producers. Recent empirical studies have highlighted the very high barriers to entry and frequent frictions encountered by individual (small) businesses in everyday productive activities, especially in poor countries (Djankov, La Porta, Lopez-de-Silanes and Shleifer, DLLS, 2003).

Of course, entry barriers could represent optimal regulatory arrangements to protect consumers or ensure stability. DLLS (2003) and Doing Business (2005) show, however, that entry costs and entry barriers for business are often more onerous and higher in poor than in rich countries, suggesting that the barriers retard growth rather than serve efficient purposes. Indeed, Laeven, Klapper and Rajan (2003) and others present evidence that these barriers do not seem to serve efficiency purposes. The removal of such barriers to entrepreneurial activity is frequently mentioned in EC, World Bank, World Economic Forum and other “competitiveness” type reports, also suggesting inefficiencies.

In fact, many complex and formalistic rules appear just to create opportunities to extract bribes, the so-called tollbooth hypothesis (Shleifer and Vishny, 1998). In many countries, productive individuals suffer large appropriations in interactions with public officials. The correlation between indexes of formal and informal barriers and corruption is then also large and quite significant (DLLS, 2003; Perotti and Volpin, 2004), providing support for the tollbooth view.

The way many entrepreneurs escape formal barriers and onerous requirements is by remaining in the informal sector. This undermines their access to finance, however, limits their trade opportunities, keeps them dependent on established firms and generally undermines their ability to grow (Demirguc-Kunt, Love and Maksimovic, 2004). Furthermore, it reduces their voice in economic and political decision-making. Barriers to economic participation seem to ultimately favor established interests, limit growth of less connected and thus can lead to further inequality.

Financial constraints as a special large barrier. One of the roles of properly functioning credit and equity markets is to provide a level playing field and to equalize opportunities

for the less wealthy but talented individuals. So a central role for a financial system, and thus financial reform, should be helping the diffusion of economic opportunities and thereby reducing inequality. Lack of financial access can be both a direct and an indirect entry barrier to growth. External financing and other forms of financial services are often needed for investment and lack of a well-functioning financial sector thus represents a direct barrier. From a tollbooth perspective, denying access to financing will often be very effective as finance is a less visible channel to stop entry and reduce competition. Financial decisions are technically complex, yet involve much subjective assessments. Blocking access to financing may thus attract less attention than using other barriers more subject to external scrutiny. It can, for example, be easier to deny finance to an entrepreneur than to refuse a license.

Lack of financing can also be an indirect barrier. As money is fungible, presumably, whatever the source of entry barriers, sufficient cash in advance can overcome some of the obstacles. Many administrative barriers may be overcome with sufficient funds, for example, as money can buy licenses and access to politicians.² Cheaper and easier access to external financing can thus provide the necessary up-front resources to overcome at least some of these barriers.³ More generally, poor financial sector development can hinder growth, including through the lack diversification of risks, which in turn can lead to a low level equilibrium in which less specialized and less productive, but less risky technologies are used instead of more specialized and more productive technologies (see Saint-Paul, 1992 for such a model).

Empirical evidence supports the importance of finance. While conceptually, finance may be considered a special barrier, in the end, it is an empirical matter: how important is access to finance relative to other barriers to entry and growth? As much recent evidence has shown, access to finance is critical for growth and the importance of financial sector

² Exceptions are presumably barriers set up to limit entry discriminatively, by ethnic, national, regional, religious or other non-income/wealth criteria.

³ This is not an advocacy for subsidized credit since, especially in highly corrupt societies, granting funding to entrepreneurs without tightening standards in the public sector may increase demands by corrupt public officers and skew access. It rather advocates fair access to financial services.

development for growth is well documented empirically (Levine 2004 reviews). Some of this evidence is, however, subject to the criticism of identification as, on a cross-country basis, many barriers are highly correlated with limited financial sector development. Some survey evidence indeed suggests that the importance of financial constraints has been exaggerated relative to such obstacles. Johnson, McMillan and Woodruff (2003) find that in surveys, Eastern European entrepreneurs rate property rights as more important than finance. Other surveys also suggest that other barriers contribute more to constraining firm growth than finance does.⁴

Yet, much other macro and micro evidence supports the important of finance, even in the face of other barriers, for reducing inequality. The general evidence suggests that financial deepening does not adversely affect inequality. In a cross-country study, controlling for the possibility of reverse causality, Beck, Demirgüç-Kunt and Levine (2004) find that financial intermediary development is correlated with decreased income inequality, although this may reflect a better institutional framework that codetermines both financial development and broader access to finance. There is evidence that inequality decreases as economies develop their financial intermediaries (Clarke, Xu, Zou, 2002). Also, consistent with the insight of Kuznets, they find that the relation between the Gini coefficient and financial intermediary development depends on the sectoral structure of the economy: a larger modern sector is associated with a smaller drop in the Gini coefficient for the same level of financial intermediary development. Honohan (2004) finds that financial depth indicators (domestic credit to GDP) are significantly positive in explaining poverty in a standard cross-country regression specification.

In part finance may rank high for growth and reducing inequality since cash may overcome many of these other barriers. But it may also reflect that evidence to date on the importance of finance has focused on the depth (or size) of the financial system.

⁴ Dollar and Hallward-Driemeier (2000) in a study of Thai firms before the East Asian financial crisis find that in terms of major bottlenecks to productivity growth, finance ranks after corruption, customs administration, red tape, and labor market issues. Similar results were reported for other East Asian countries after the 1997 crisis (see Colaco et al. 2000).

Much less attention has been given to the issue of breadth of access to the system: does finance reach all or just a few? Access to finance can be unequal precisely because it reflects the same underlying distribution of power that creates the other entry barriers. Even though a deeper financial system may be associated with economic growth and improve in income across all levels, perhaps very few firms and households benefit from deepening. The resulting growth may then be of lower “quality”, as it fails to renew the set of productive agents, or it may be vulnerable to a backlash, as it increases inequality further.

Access to financing is skewed. Indeed, much micro-evidence suggests that access is quite skewed. Although also weak and often neither comparable, some data on firm access to financing have more recently become available. Specifically, the World Bank Investment Climate Assessments (ICA) that have been conducted in the last few years, asks firms whether access to financing presents major or severe obstacles to the operation and growth of their business. About a quarter of the firms on average complain about the lack of external financing, with large variations though, from less than seven percent for Latvia and Lithuania, to more than 50 percent for several countries and a high of 60 percent for Brazil. Importantly, the percentage of large firms with complaints is less than that for the smallest firms, on average some eight-percentage points, but sometimes as much as 10 to 20 percentage points.

There is evidence that much small scale entrepreneurial activities is cash constrained; even in developed countries, many small entrepreneurs have funded start up costs with credit card loans. In developing countries, remittances from family and friends are often the sole source of small scale capital funding (Woodruff, 2003). Many (cross-country) empirical studies rank a lack of finance high among entry barriers for new firms, in turn adversely affecting inequality. Using an enterprise survey database covering 48 countries, Demirgüç-Kunt and Maksimovic (2002) find that financially constrained large firms can access some external finance, whereas small firms do not. Laeven (2003) finds firm leverage is concave in firm size, i.e., lowest for small firms, highest for medium-sized firms and in between for the largest firms. This suggests that small firms use mostly

own resources, medium firms rely more on bank and debt financing, and large firms can raise equity financing or otherwise have access to intra-group resources.⁵

The skewness is also reflected in households' access to and use of financial services. The diffusion of formal forms of credit is minimal in the poorer segments of the population (Claessens 2005 reviews). Work by the Consultative Group to Assist the Poor (CGAP), access studies for Brazil, India and South Africa show that few households have access to financial services. Fewer than two out of ten people in Latin America currently have accounts at financial institutions. Bank accounts are few in Mexico, less than 25% of the population has accounts (see Gaskey et al. 2004). In most African countries, access is even lower.⁶

Access to finance can also be a way to overcome other barriers. There is also evidence that access to finance affects the ability to overcome other barriers. The major role of diversified groups in developing countries is mostly attributed to their superior ability to overcome "market imperfections" or "accessing scarce resources", e.g., financial resources or political access to overcome policy "barriers." Khanna and Palepu, 2000, find that the value of groups in India derives from their better access to finance and political support. Beck, Demirgüç-Kunt and Maksimovic (2003) find evidence suggesting that firms in the formal sector in countries with weak creditor protections are larger, maybe to overcome access to finance barriers.

Access may be unequal due to economic, technical and institutional difficulties. There are many economic, technical and institutional explanations why access to finance can be unequal. Although finance can support the enhanced participation of individuals in autonomous production, financial services and financial contracting may establish

⁵ Kumar, Rajan and Zingales (2001) using data on firms size within Europe and find that as the judicial efficiency improves, firms in capital intensive industries become relatively smaller and the difference in size between firms in physical capital intensive industries and those in less capital intensive industries diminishes. This suggests that institutional factors influence the ability of firms to grow, although they did not check the importance of financial sector development.

⁶ These numbers will have to be seen in perspective as in many of these countries, the sustainable demand for financial services is also very correspondingly low, e.g., many poor people do not have a need for financial services.

relatively high thresholds for poor individuals and new firms. The formal financial sector often refuses to deal with individuals who do not have an official address, or some formal education, or some basic certification. Even in developed countries, often dual financial services markets exist in which formal, insured depository institutions largely serve middle- and upper-income clients, and check cashers and other basic service providers largely serve low-income households.

Indeed, households and firms often say that financial institutions do not adequately serve them. Complaints typically include: the right type of financial services are not provided; transactions costs for dealing are too high, e.g., procedures for opening an account or getting a loan are too cumbersome and costly (with high rejection rates); financial institutions demand collateral, which (poor) borrowers typically lack; and more generally financial institutions have high thresholds, e.g., they desire too much transparency or too much literacy. Financial institutions in turn respond that they cannot provide services profitably: the poor seek products like small savings, lending and insurance (life, health, crop), which are hard to provide; small borrowers borrow frequently, repay in small installments, making it very costly; and the underserved are new, not experienced in business, etc., making them poor credits. In short, the provision is considered to be a too high-risk, high-cost proposition.

Explanations for the lack of services lie with both financial institutions' constraints and constraints arising from countries' institutional environment. For financial institutions, access has much to do with scale, which is often too small. The fixed cost of providing small-scale credit may be high, perhaps because of fixed screening costs or subsequent moral hazard, making it hard for financial services providers to offer services in a profitable manner. Some argue that network externalities can prevent financial services providers from catering to the poor, while others argue for adjustment costs or inertia. Programs such as the Community Reinvestment Act in the US (see, for example, Evanoff and Segal 1996), the tendency of public authorities to force banks to lend to underprivileged groups, requirements on banks to maintain a certain number of branches

in certain areas or to service certain groups, or publicly funded credit lines are partly a response to these problems, although they raise many new problems.

Another reason often mentioned for limited access is the high costs of enforcement. Indeed, Beck, Demirgüç-Kunt and Maksimovic (2003) report evidence that access to finance by small firms is most severely affected by weaknesses in the legal system. Yet the lack of service provision for lower segments extends to many non-credit services, which do not involve default risk, thus ruling out explanations solely based on enforcement costs. Furthermore, in many developing countries these enforcement costs are high because of institutional failures, which at least in part appear to be remediable. And it is not just the cost of enforcement, but also the fact that there is no proper legal framework that hinders the growth of these firms. As De Soto (2000) has argued, many individuals in developing countries lack any basic legal recognition of their own assets or status to be able to participate in formal contracting.

Self-reinforcing mutual commitment schemes (rotating savings societies, cooperative banks, micro finance institutions, etc.) can substitute for weak external enforcement and allow for funding of activities in the poor layers of the population. Indeed, they can be appropriate to the needs of the lowest-income people in developing countries. A small number of investors and firms may in fact overcome agency conflicts and enforcement issues. This form of self-enforcement can also apply to capital markets. Frank and Mayer (2004) argue that the success of the British capital markets in an era of limited regulation owed a large part to the local market character of the stock exchanges at that time. Yet, the reach and scale of informal markets can easily be overestimated. Honohan (2004) reports that the spread of microfinance does not appear to exert effects on poverty additionally and independently from general financial sector development. Clearly, for many markets informal arrangements are not, or no longer, an option today.⁷

⁷ Berger, Hasan, and Klapper (2003), for example, report evidence that greater market shares and higher efficiency ranks of small, private, domestically-owned banks is associated with better economic performance, and that the marginal benefits of higher shares are greater when the banks are more efficient. They find, however, only mixed support found for the hypothesized transmission mechanisms through improved financing for small and medium enterprises or greater overall bank credit flows. For the mutual

While not incorrect, most of these explanations are not sufficient. Most of the evidence so far makes it tempting to attribute the skewed access to finance to general difficulties to lend to small firms and households and to weak institutional environment, including causes such as weak legal system, poor supervision and regulation, or perverse governance factors due to ‘culture’, etc. Indeed, Beck, Demirgüç-Kunt, Laeven and Maksimovic (2003) report evidence that it is the institutional environment which matters most in explaining cross-country differences in external financing. Thus finance would no longer be a barrier, if countries were only to adopt better laws and policies. Yet this ignores two aspects: financial services providers can already overcome barriers and lending is consequently often more skewed than barriers call for; and the institutional barriers are endogenous to inequality. While not comprehensive, some evidence supports both these arguments.

First, many of the so-called barriers can be overcome. ICICI Bank in India has successfully challenged the notion that banks cannot cater to poor clients in dispersed villages, often using creative technical solutions. Recent experiences like those of ICICI bank show that the high transactions costs for small volumes and the large costs for expanding reach (e.g., the high cost of establishing rural branches) can be overcome. One option is the innovative use of existing networks. Postal systems have often-large coverage and can be used to deliver new services by many, private financial services providers. Many technological solutions now exist for small scale. Mobile banking and broadening the range of delivery points—through kiosks, small branches and joint ventures with non-banks—can increase coverage.

Scoring models for consumer-lending can facilitate lending for mass-markets. Simpler banking products, like the "Mzansi" account in South Africa, and pre-paid cards for small transactions can lower thresholds. Handheld computers have been used for quick approval of microfinance loans. Reverse factoring on the basis of an internet platform

and microfinance, there are issues of scale which would favor more mainstream banks to provide such services, which current technology can more easily allow.

has been used by NAFIN in Mexico to extend trade finance. Much innovation has recently happened in the market for international remittances where many banks have entered.

Foreign banks in developing countries have shown to be able to lend in spite of a weak-contracting environment, although to selected groups and purposes. In a review, Clarke, Cull, Martinez-Pernia and Sanchez (2003) conclude that the lending behavior of foreign banks is not different from that of local banks and better in terms of ex-post performance. Large loans in developing countries (and sometimes in developed countries as well) often have experienced higher default rates than small ones, negating the beliefs that poor access is caused by fixed costs of screening. Much of the informal lending arrangements suggest that information asymmetries cannot fully explain the lack of financing to some groups.⁸

The point of these examples is that they show that providing financial services to poorer segments can be profitable for financial institutions. Some of these innovations need regulatory changes, e.g., deposit insurance may need to be adapted to the use of mobile phones as payments devices. Still, it has become clear that banks can reach much further down and also that one needs to connect the micro-finance to the main banking system to give it the scale and technology to be sustainable and to allow costumers to upgrade.

⁸ Mian, 2004, however, shows that foreign banks lends less to sectors where information asymmetries are greater; he concludes that their lending is restricted (presumably by the parent bank) to only 'hard information' firms. These are likely to be more established firms.

Table 1: Case study evidence of finance being captured by the few

Country	Evidence	Paper
Brazil	Public financial institutions in Brazil appear to have served larger firms more than private banks have	Kumar et al. (2004)
Chile	Following liberalization in the late 1970s, groups played a perverse role with many privatizations of state-owned banks to groups of insiders	Larrain (1989)
Czech Republic	Mass-privatization in the Czech Republic delayed the establishment of a securities and exchange commission, facilitating tunneling	Cull, Matesova and Shirley (2002).
Indonesia	Market attributes large financial value for political connections, suggesting politics rather than economics determined access or rents	Fisman (2001)
France, pre-1985	Banks, protected and dependent on government support, lend to less productive firms	Bertrand, Shoar, and Thesmar (2004)
South Korea	The opening up of new segments of financial services provision was limited to insiders. Increasing openness primarily expanded and strengthened the politically most connected firms	Haggard, Lim and Kim, (2003), Siegel (2003)
Malaysia	The imposition of capital controls benefited especially firms with ties to the ruling party	Johnson and Mitton (2003)
Mexico late 1800s	There was capture of the financial sector in Mexico in the late 1800s blocking entry in emerging industries	Haber et al., (2003).
Mexico 1990s	Related lending in the 1990s was prevalent (20 percent of commercial loans) and took place on better terms than arms'-length lending (annual interest rates were four percentage points lower). Related loans were 33 percent more likely to default and had lower recovery rates (30 percent less) than unrelated ones	La Porta, Lopez-de-Silanes and Zamparippa (2002)
Pakistan	Mutual funds reform in Pakistan seems to have benefited few. Insider lending was related to political motives as political firms borrow 40 percent more and have 50 percent higher default rates, with economy wide costs of rent-seeking estimated to be 0.3 to 1.9 percent of GDP per year.	Khwaja and Mian (2004a) Khwaja and Mian (2004b)
Russia	Russia's choice of a universal banking system gave great discretion to insiders to conduct assets stripping through the loan for shares scheme. The weak political accountability could not stop the capture of state resources or protected rents	Perotti (2002), Black, Kraakman and Tarassova (2000)
Thailand	Connected lending was large before the 1997 crisis and firms with connections to banks and politicians had greater access to long-term debt	Wiwattanakantang, Kali and Charumilind (forthcoming)
United States, pre-1900	New bank licenses went largely to insiders in New York state	Haber (2004)

Source: Claessens and Perotti (2004)

Second, there are many, albeit case examples to suggest that finance is used to benefit a few (see Table 1). Some of this evidence relates to the ex-ante distortions in resources allocation. Related lending, although perhaps a second-best response to a weak property rights environment, has historically benefited only a few. La Porta, Lopez-de-Silanes and Zamparipia (2003) find for Mexico that related lending in the 1990s was prevalent (20 percent of commercial loans) and took place on better terms than arm's-length lending (annual interest rates were four percentage points lower). Fisman (2001) for Indonesia and Johnson and Mitton (2003) for Malaysia find large financial value for political connections, suggesting politics rather than economics determined access. Also for Indonesia, Leuz and Oberholzer-Gee (2003) find that corporate transparency and political connections are substitutes: firms with ties to then-President Suharto are significantly less likely to issue foreign securities. Connected firms have lower rates of return during the 1997-98 crisis than transparent firms, but did receive considerable support during this period. Faccio, 2003 reports that connected companies enjoy easier access to debt financing, lower taxation, and higher market share. She finds that benefits are particularly pronounced when companies are connected through their owner, a seasoned politician, or a minister and when the connected firm operates in a country with a higher degree of corruption. Also, stock prices increase by 2.59 percent upon announcement of a new connection, but only in highly corrupt countries. Bunkanwanicha and Wiwattanakantang (2005) find value from political relationships reflected in stock prices upon the election of a tycoon as prime-minister in Thailand.

Credit lines provided by international agencies seem to be made available more so to large firms (OED 2004, World Bank). State bank lending (under soft-budget constraints) has been inefficient (LLS 2000, Caprio, Barth, Levine, 2000) and most often benefited special sub groups, typically the largest SOEs and their employees (see also Dinc, 2003 and Faccio, 2004). Some similar results obtain for directed credit programs. Schwarz (1992) finds that, despite its huge volume, directed credit policies in the US (education loans, mortgage, and agriculture) had had little impact on growth. The credits have led to increasing credit to the target group, but not necessarily increasing investment by that

group, suggesting political economy factors to be important in these programs. Laeven (2000) finds that gross safety net subsidies are larger for banks that have concentrated ownership, are affiliated with business groups, and are located in countries with lower income per capita and poorer quality and weaker enforcement of the legal system. These findings suggest that the moral hazard behavior of banks depends on its institutional environment and its corporate governance structure.

Evidence on the ex-post performance on lending also suggests skewness. Losses on larger loans have been spectacularly high in weak enforcement countries, again suggesting that such loans were channeled to well (connected) groups. La Porta, Lopez-de-Silanes and Zamparipia (2003) find for Mexico that related loans are 33 percent more likely to default and, when they do, have lower recovery rates (30 percent less) than unrelated ones. Furthermore, the fraction of related lending almost doubled for the banks that subsequently went bankrupt and increased only slightly for the banks that survived, suggesting that related lending was a manifestation of looting in part due moral hazard problems. In terms of ex-post profitability, government banks perform uniformly poorly and only survive due to strong government support (Mian 2003).

Rather, the barriers are outcomes. What the evidence rather suggests is that the poor access and weak institutional environment may itself be the outcome of deliberate choices. The formal financial sector may fail to supply funding to these segments not only because of “natural” enforcement difficulties but also because of political economy factors and associated biases in the institutional environment. The lack of access may reflect preferences in the governance of the financial sector and supporting institutional frameworks (judicial system, public administration, etc). In other words, barriers are not all natural, but often “policy” induced to favor some groups. Influence groups keen to limit increased competition by new entrants can do so when reform process, governance of relevant institutions (public and private) is captured by specific sectors, firms or groups. The risk of political capture of reforms relates of course more generally to ex ante inequality, and should be a factor in assessing and designing all types of structural

reforms, but maybe especially important in the financial sphere where manipulation and abuse are easier to perform and hide. We analyze this next.

2. *The effects of (in-)equality on financial sector reform and development.*

The evidence so far suggests that political economy arguments linked to inequality can explain in part why access has been skewed, why financial reform, including institutional development, to enhance access has not been considered more important and why such institutional development has been not more successful and sustained. In this section, we present our arguments on how such effects may have arisen and review evidence on the possible channels. If there are indeed important channels from inequality to access through the institutional environment, then the issue becomes understanding better what the exact mechanisms are by which reforms do not occur to begin with, get high jacked or manipulated, or are not sustainable. The three channels through which inequality is likely important for financial reforms are:

1. Inequality may prevent genuine financial reform as incumbents block or capture the process of financial reform.
2. The limited gains or even perverse effects of financial reform may reflect specific features of reforms, as insiders manipulate its design, enforcement, or both.
3. Inequality as an interim outcome, or crises driven by abuse by strong interests, may undermine reforms from being sustainable due to resulting lack of political support or even backlash.

Inequality weakening institutional development and hindering reform. The importance of a good institutional environment for growth has been much documented, also for the financial sector (see Djankov et al. 2003 for a general review and Beck and Levine, 2004 for a review of finance). Indeed, Acemoglu, Johnson and Robinson (2002) report empirical evidence that poor institutions explain macroeconomic performance (in terms of current levels of GDP) better than policies do (although there are questions on reverse

causality, see Glaeser et al., 2004, Rigobon and Rodrik, 2004; see also Easterly and Levine, 2003). In turn, excessive concentration of influence can affect the institutional environment, among others through the quality of legislation and enforcement thereof. Inequality allows some groups to operate above the regulatory framework or capture its design, and affects the enforcement of existing laws. More generally, capture of institutions by stronger interests undermines the reliability of private contracting, complicates access and disenfranchises outsiders.

In many countries indeed, the operation of legal, political and regulatory institutions is subverted by the wealthy and the politically powerful for their own benefit (Glaeser, Scheinkman, Shleifer, 2002). As a consequence, the quality of the institutional environment and the degree of inequality are negative correlated (Perotti and Volpin, 2004), with adverse effects of growth. Economic inequality might in general impede growth (for a survey see Aghion, Caroli, and Garcia-Penalosa (1999) and the forthcoming World Development Report, 2005). The evidence of these perverse effects of inequality is mostly reported in reduced forms (e.g., through regressions of growth or investment on inequality, e.g., Alesina and Rodrik, 1993; Alesina and Perotti, 1996). Reduced form evidence suggesting that concentration of wealth is associated with higher poverty exists as well. Honohan (2004) provides evidence that the more concentrated is income at the upper levels of society, the higher is the poverty headcount, even conditional on the mean income of the non-rich.

There is some specific evidence for the financial and corporate sectors, although these are often just associations. Banking systems with more concentrated ownership structures are associated with weaker institutional environments (Caprio, Levine, and Laeven, 2003). Morck, Wolfenzohn and Yeung (2004) review the literature how at the economy level, extensive control of corporate assets by a few families can distort capital allocation and reduce the rate of innovation. They argue that families appear to influence the development of both public policy, such as property rights protection and enforcement, and institutions like capital markets. Morck, Stangeland and Yeung (2000) indeed show that a country's per capita GDP grows faster if its self-made billionaire wealth is larger as

a fraction of GDP, but that per capita GDP growth is slower in countries where inherited billionaire wealth is larger as a fraction of GDP. And Morck and Yeung (2003) show that there is a strong correlation between the degree of family control and measures of entry barriers, judicial system inefficiencies and political and tax system corruption. They also find that the separation of ownership and control—through pyramids, differential voting and other arrangements—aids to the inefficiencies.

There is some more specific evidence on assets, such as land or years of schooling, being unequal available because of institutional deficiencies and adversely affecting growth (Banerjee, ..). There is some evidence specific to regions and countries. For example, there is a clear association between the concentration of ownership of the corporate sector in East Asian countries and the development of the countries' institutional environment (Claessens et al. 2000). Haber (1991) shows the impact of concentrated industrial wealth on capital market development in Brazil, Mexico and the US. The channels vary by country. In many countries, the political elite is the same as the corporate sector elite (e.g., Indonesia with Suharto, the Philippines with Marcos, Italy with Berlusconi), making for a direct link between countries' ownership concentration and institutional environment. In most other countries, there are indirect links. Glaeser, Scheinkman and Shleifer (2002) report that there were important adverse effects of inequality on economic and social progress for the U.S. during the Gilded Age and in Russia in the 1990s, in what they call the subversion of legal, regulatory, and political institutions by the powerful.⁹

If institutions are undermined by the powerful and worse institutions in turn hurt growth, why is there no response as the powerful themselves may in the end be hurt themselves by reduced output? Why, if elitists were so powerful, could they not introduce valuable reforms and capture part of the increased output? Yet, many case examples exist why output-enhancing reforms were not undertaken by elitists or groups aligned with them.

⁹ At the same time, concentrated ownership need not be detrimental to growth. For example, De Long (1990) argues that in the late 19th and early 20th century United States the J.P. Morgan group, a powerful force in many corporations at that time, was instrumental in financing numerous innovative ventures, and in lending its financial credibility to entrepreneurs.

Acemoglu (2003) argues for the general case that reforms, or at least some type of reforms, can undermine the mechanisms by which the elite exercises control, thus making output-enhancing reforms unattractive. For example, railroads were not allowed to be introduced in some countries in 19th century Europe in part as they would facilitate rural people to congregate in cities and spread news more easily, potentially leading to uprisings. Blocking entry may be especially important to maintain levers of control and entry appears to be suffocated especially in most autocracies, suggesting that the established elite interests did not stand to gain from reforms increasing access. Many developing countries with high inequality seem to fall in this category. Another argument is that, when undertaken, reforms do not lead to any supply response as agents expected any gains to be taxed away (see Acemoglu 2003).

These relationships can lead to perverse dynamics. While over time the comparative advantage in entrepreneurship shifts away from incumbents, this may only strengthen the resistance of the elite as a large stake in a smaller pie may well be better than a small slice of a larger pie (Bourguignon and Verdier, 2000). Indeed inequality is not only also associated generally with higher barriers against entry, but they often appears to be preserved, a form of economic entrenchment (Morck and Yeung 2003, Chong and Gradstein, 2004). As noted, entry barriers tend to be larger in poorer countries, providing further suggestive evidence of the perverse dynamics. Khanna and Palepu (1998) show that there has been an increase over time in-group scope in Chile and India, the strength of social and economic ties that bind together group firms, and self-reported intermediation attempts by the groups, in spite of the development of market intermediaries during this period.

Although economic entrenchment can be a self-sustaining, stable equilibrium that seems to characterize many, it does not characterize all oligarchic capitalist economies. The desire to keep control by entry barriers is among others affected by the political system. Acemoglu (2003) and Perotti and Volpin (2004) show that the degree of democracy can weaken the strength of elites in blocking entry. Of course, inequality also undermines political accountability, so there is an indirect link as well, but there is a clear

independent effect of political accountability, both theoretically and empirically. Countries with more democratic and limited governments then also have fewer entry regulations, even controlling for GDP per capita (DLLS, 2002, see further box 1).

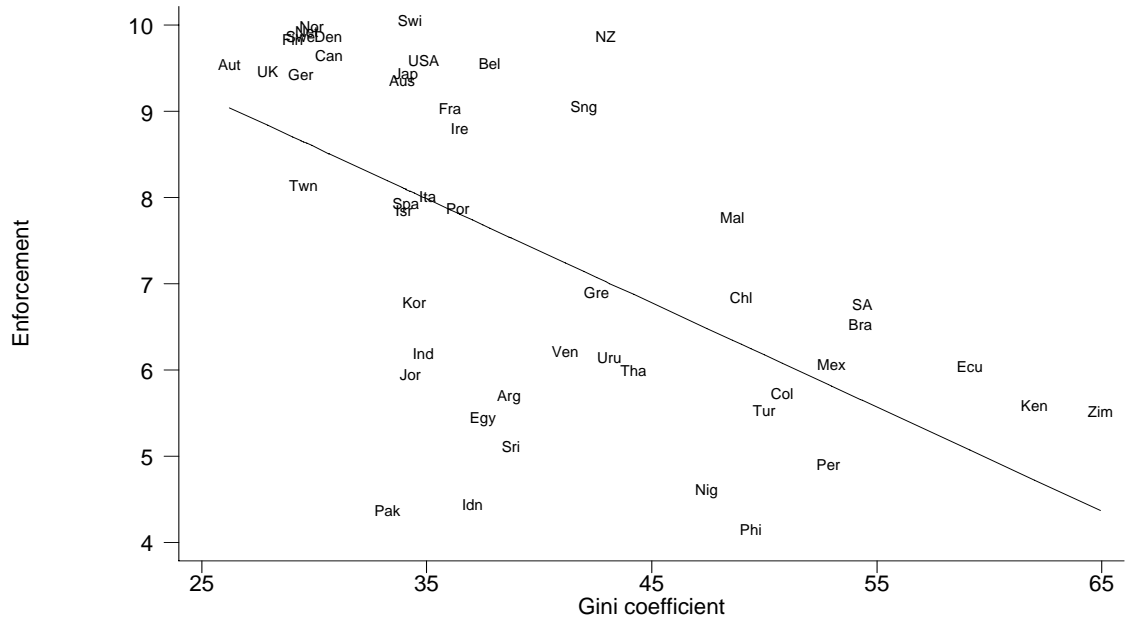
Box 1: Formal and Informal Barriers to Entry

The ability of small firms to operate in the formal sector depends on both formal and “informal” costs associated with a country’s institutional environment. Formal entry costs include the (perceived) costs and time of registering, taxation, and costs of compliance with regulations. Djankov et al (2002) show that explicit entry barriers are higher in more corrupt countries, and generally in countries with a less accountable political system. In addition to formal barriers, informal barriers exist. Informal costs are due to a poor contractual enforcement, arbitrary regulatory pressures, or predatory behavior by economically or political influential agents. They manifest themselves in weak, selective or corrupt enforcement of rules, contractual and property rights, which undermine the level playing field for poorer entrepreneurs. The informal barriers, i.e., “quality of enforcement,” are a key determinant of entry, even after controlling for explicit entry barriers and other measures of investor protection (Perotti and Volpin 2004).

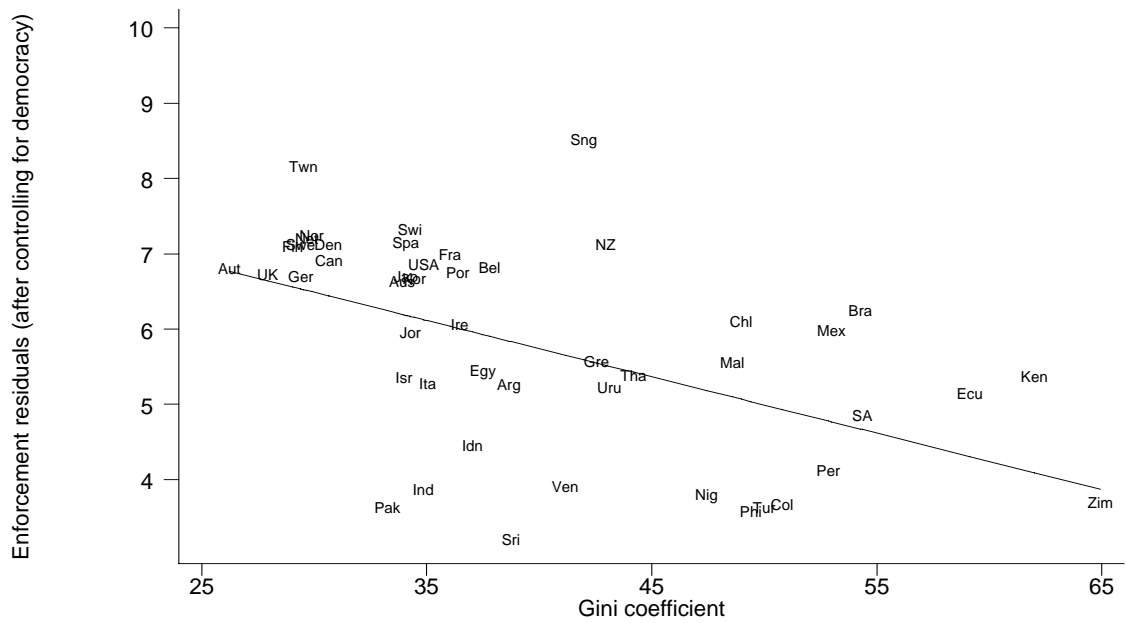
The Perotti and Volpin (2004) model suggests that informal barriers will be high in countries with an unequal distribution of economic and political power. They show that across countries contract enforcement is well explained by both political accountability proxies and measures of inequality, even after controlling for legal origin and per capita income (Graph 1-3 depict the evidence concerning the impact of economic inequality and political accountability on enforcement). Their results are robust to introducing per capita income, assuaging concerns raised in Glaeser et al. (2004) that institutional quality increases with economic development.

This suggests that the distribution of political and economic power affects the reliability of laws and thus the ability to raise external funding. Since new entry is an important engine for economic renewal, and possibly long term growth, political institutions (i.e., mechanisms which constrain public abuse) appear to matter more than legal institutions (which constrain private abuse). These results echo the conclusions in Acemoglu and Johnson (2003), where political constraints on the executive have a major impact on growth, while measures of legal efficiency affect financial development but do not directly raise growth. These results suggesting that accountability, which can be interpreted as a measure of the concentration of political access, has a first order effect on economic development.

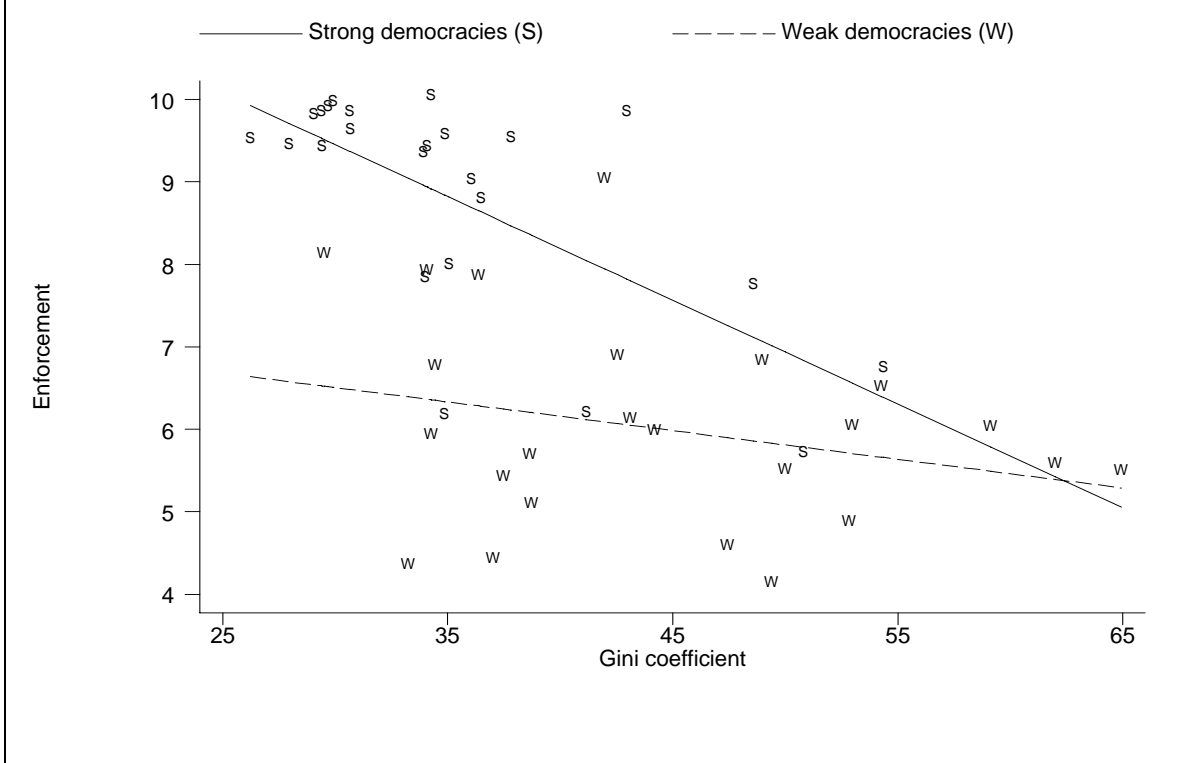
Graph 1: Enforcement and income inequality ($R^2 = 0.374$)



Graph 2: Enforcement and inequality, controlling for political accountability ($R^2 = 0.628$)



Graph 3: Enforcement and inequality for highly and poorly accountable political systems



What is special about finance? The general case from inequality to the quality of the institutional environment is thus clear and becoming well documented, but what is special about finance? Are there special reasons to block financial reform and the institutional environment important to finance, more so than other channels? One reason may be that the tools in the financial system are more “efficient” to retain control as they more easily avoid public scrutiny and thus political backlashes. Tools used to keep control in the financial system are many: poor creditor and equity rights protection; weak enforcement of investors’ rights; limited transparency; high barriers to entry; unclear dividing lines between public and private interests; close public/private personal relationships; etc. Intermediate finance (banks, pension fund, mutual funds) is very institution-intensive and is particularly vulnerable to a deliberately skewing of access using subtle means. Arguably, policies in the financial sector are easier to manipulate under the guise of public policy than policies in other sectors are. Limited transparency and tight entry regulations can be defended as helping financial stability. Purposely unclear regulatory lines can be justified on overlaps between public and private interests

(monetary policy, special nature of banks, etc). Close personal relationships can be seen as needed by the specialized nature of businesses.

A second reason is that control of the financial system entails control over many parts of the economy, because control structures are naturally associated with capital contributions, at least to the extent they are formally codified. Any major expansion of existing capacity or new entry also requires external financing by intermediaries (rather than individuals). Control over the financial system can thus be the most effective to control the overall economy. This, combined with the fact due to a needed concentration of expertise, etc. much of financial contracts are actually managed by delegated agents (banks, mutual funds, other financial intermediaries), makes finance easier to manipulate. An unequal wealth distribution is therefore likely associated with the financial system blocking initiatives by new entrants. Case evidence supports this, such as the description of the capture of the financial sector in Mexico in the late 1800s (Haber et al., 2003).

Second: undermining the intended implementation and goals of reform. In principle, proper financial reforms should enhance access by cash poor productive individuals and activities, and thus create opportunities for previously disadvantaged groups. Financial reform in a context of high inequality, however, leads to the risk that the design of regulatory reform is captured by the powerful. This can produce an ex ante distorted process, so that it can be exploited ex post by those in the right positions. Especially in developing countries, the more general gains of financial liberalization may not arise or be undone due to (opportunistic) actions by the established elite. We consider evidence on these possibilities, but first briefly review the general evidence on financial liberalization and its effects on access to finance.

The experience of financial liberalization in developing and developed countries over the past two decades has been much studied. Yet evidence available suggests that there are reasons to be concerned, mainly because among economists, the focus has been on the financial constraints, investment, growth and stability links, and less on the distributional effects of reforms. There is general evidence that domestic deregulation and

liberalization of capital flows have increased the supply of domestic capital, attracted foreign capital, or contributed to a lower cost of capital, more relaxed financing constraints, etc. and in turn to increased investment and growth, at least in the short to medium term (Henry 2002, 2003, Levine and Zervos, 1998, Bekaert and Harvey 2003, etc.). This evidence is, however, still consistent with existing elites or groups of established, well-connected individuals having capturing much of these gains.

Increasingly indeed, evidence suggests that the benefits of financial liberalization may be fairly concentrated and accrue largely to the better, larger private firms, already in existence.¹⁰ Case examples are many. Many privatization of state-owned banks happened to groups of insiders—Chile in the 1970s (Velasco, 1988, Valdes-Prieto, 1992), Mexico in the 1980s (Haber and Kantor 2004), and Russia (Claessens and Pohl, 1994, Perotti 2000; see further box 2 on Russia). Apart from preventing foreign entry thus favoring local interests (Clarke et al. 2003), the provision of licenses has often been directed to insiders, as has happened in Indonesia (banks) and Thailand (non-bank financial institutions). The opening up of new segments of financial services provision was often limited to insiders, as happened in Korea, where chaebols only were allowed to open non-bank financial institutions (Haggard, Lim and Kim, 2003).

¹⁰ The reason is in part due to data availability: it is easier to document the gains for existing firms than new firms for which one does not have any historical data to compare with. As such, it is harder to refute that new firms did not benefit from financial liberalization.

Box: Too much and too little regulation: Russia before and after the transition

There are many forms that regulatory policy in the financial sector may undermine access. The classic form is financial repression, coupled with tight control by strong economic and political interests over the allocation of resources by domestic financial institutions. In such cases, only well connected or well paying individuals may gain access to the necessary resources to operate as independent producers. This described well the financial system of many developing countries before the 1980s. Yet a very fast process of financial liberalization may produce ultimately the same effect.

Consider the liberalization of banking in Russia. Within a couple of years of liberalization, where previously were four state banks, around three thousand banks were created – one could argue that this was prime evidence that no elite was blocking entry per se. In practice, such rapid entry in a regulatory power undermined any chance of regulatory oversight, and compromised the public perception of what a bank is and how it operates, undermining the very foundation required for the development of the domestic banking sector. In practice, many of these “banks” were not banks but private fund management entities used to channel capital flight. Those which raised deposits from the general public proceeded to lend the cash to insiders, gamble it irresponsibly, or simply shipped it abroad, leaving the banks as empty shells full of liabilities.

Banks could get away with such behavior not just because rapid entry overwhelmed the (rather unprepared) bureaucrats, but also because the banking lobby further promoted laws that granted banks an extraordinary freedom to operate and dispose of other people’s money. Russia endorsed the “universal bank” model, for example, hardly a structure suited to a legal and regulatory vacuum. Bank lobbyists also ensured that banks were exonerated from the new commercial bankruptcy code (the bankruptcy code established before the 1998 crisis vaguely stated that banks would be subject to a specific bankruptcy legislation, which was not even tabled before 1998). The universal banking structure and lack of bankruptcy system contributed to the severity of the financial crisis of August 1998, resulting in massive losses to depositors, foreign investors, and cost to the state budget (as many liabilities were transferred to the state-owned Sberbank).

Source: Perotti, 2002.

The institutional environment following reforms has often been designed so as to benefit insiders. Often the form of liberalization was stacked against newcomers by, for example, imposing unnecessary high capital requirements for new banks (Malaysia, Thailand, others). Misuse has often been due to a deliberately biased design of reform. In capital markets, indirect tools to channel resources rather than explicit, formal interventions were often used, as they are even more effective to target benefits. Listing rules were designed to benefit the insiders. Poor regulation and weak enforcement in many liberalizing

markets meant that the insiders gained the profits/rents from capital markets development through expropriation of minority shareholders (LLSV 2000, Claessens et al. 2000; see Claessens 2005 for a review).

Capital account liberalization occurred mostly in countries with higher income inequality, suggesting that insiders made it a priority (Quinn, 2000). Alesina, Grilli and Maria Milesi-Ferritti (1993) find that in OECD countries a majority government was more likely to use capital controls.¹¹ Capital account liberalization, while associated with increases in average growth, seems to have increased inequality as few insiders gained access to external resources to expand established firms. Increased capital mobility seems to lead to increases in income inequality caused by a decrease in the income shares of the lowest income quintiles and an increase in the income share of the highest income quintile (Brilman, 2002). One of the main channels has been concentrated political access. Siegel (2003a) finds that increasing openness in Korea primarily expanded and strengthened that country's politically most connected firms. Another channel has often been capital flight: the capital account convertibility introduced in many Latin America and African countries, for example, facilitated capital flight to offshore accounts favoring the rich. Accordingly, the gains of capital account liberalization have been highly concentrated and often lost.

Biasing the enforcement of reasonable rules may be particularly effective. Financial reform, maybe more so than other structural reforms, requires institutions, whether existing or newly created, to enforce the new rules and to promote more access by decentralized contracting. Institutions are more easily captured with greater inequality. In Russia, serious reform the failures involved the capture of state resources or protected rents, which weak or missing institutions could not stop (Black, Kraakman and Tarassova, 2000; Johnson, Macmillan and Woodruff, 1998). Other examples of capture of institutions are plentiful, e.g., the mass-privatization of state-owned enterprises in the Czech Republic delayed the establishment of a securities and exchange commission

¹¹ Also, capital controls were more likely when the central bank was less independent, suggesting that capital control were used to help finance budget deficits.

(Cull, Matesova and Shirley 2002). In Thailand and Indonesia following liberalization many talented bank officials in a position to take advantage of the changes joined the private sector, undermining the institutional quality of the government and creating much scope for connections. Sometimes the methods can be blunt, such as the buying of an official for a specific action through a bribe. Often they will more indirect, e.g., by promising a job in industry to somebody post-supervision career (formalized in Japan by the “retire to heaven” system), or by having the daughters of chaebols marry promising bureaucrats in the ministry of finance as in South Korea (Haggard, Lim and Kim, 2003).

In terms of outcomes, there is ample evidence of distorted rules following liberalization leading to limited access and costs. A general suggestive piece of evidence is the remarkable diffusion of highly diversified family-owned groups (Fisman and Khanna, 1998), indicating that in a situation of scarce financing, few individuals may capture most attractive investment opportunities. Following liberalization in Chile in the late 1970s, groups played a perverse role in the privatization process (Larrain, 1989). Financial liberalization in Mexico led to large scale connected lending in the mid-1990s. There are powerful episodes of Russian connected lending in the late 1990s (Laeven, 2001; Perotti and Gelfer, 2000, Perotti, 2001), and of large, connected conglomerates in East Asia, triggered in part by financial liberalization (Claessens et al. 2003). Khwaja and Mian (2004) document how in Pakistan lenders favor politically connected firms following reforms.

In many emerging markets, capital markets reform has end up benefiting a few individuals. The benefits of stock market liberalization appear to be in particularly highly concentrated: income share growth accrued almost wholly to the top quintile of the income distribution at the expense of a “middle class,” the three middle quintiles of the income distribution, with the lowest income share remained effectively unchanged in the event of liberalization (Das and Sanket, 2003). Khwaja and Mian (forthcoming) show the misuses following mutual funds reform in Pakistan. While the mechanisms have varied, from skewed access to the lack of ex-post minority rights protection, all have produced mostly gains for insiders.

The post liberalization experiences with financial crises have been particularly worrisome. The risks of a bank running into a crisis have been shown to be a function of the degree of inequality and political economy factors reflecting unequal political access. Bongini, Claessens and Ferri (2000) show for East Asian banks that "connections" with industrial groups or influential families increased the likelihood of distress in the financial crisis, suggesting that supervisors had granted selective prior forbearance from prudential regulations. The close links between public and private interests make the financial sector a good place to engage in looting during turbulent periods. Dooley (2000) actually argues that financial crises are mainly manifestation of underlying political processes aimed at "stealing" from the government.

In developing countries, crises have brought heavy tolls, in terms of fiscal costs and economic disruption, imposed on society (such as in East Asia, Mexico or Argentina). Massive misuse of bank lending has often been facilitated by moral hazard brought on by the public safety net for banks (Akerloff and Romer, 1993). Importantly, banking crises' costs have been socialized in a highly repressive fashion as a poor institutional environment allocated losses to groups according to their power positions using various instruments (e.g., inflation, fiscal cuts following bank bailouts and refunds of lost deposit, etc). The distributional impact appears clear: financial transfers during crises are large and expected to increase income inequality and to be very regressive (Halac and Schmukler, 2003). The impact of crises may not be on the poorest though, who hardly participate in the formal economy and have little to lose, but often on the middle class. Maloney, Cunningham and Bosch (2004) found that in Mexico during 1992-1995 those households headed by the less well educated (poor), single mothers or those in the informal sector do not appear to experience disproportionate loss of income in crisis years.

Yet overall poverty seems to rise more in financial crises (Manuelyan-Atinc and Walton 1998). Labor income (as a share of value added) often falls following financial crises. Diwan (1999) finds that the labor share in GDP usually sharply falls following a financial crisis, recovering only partially in subsequent years (and there is also a long-run

downward trend in the labor share). He finds evidence to support that the resolution of crisis involves changes in distributions, suggesting a political economy channel.

Experiences with enterprise privatization are also relevant here. The general evidence of privatization is favorable in terms of improving firm performance (see Kikeri and Nellis, 2004). Evidence on privatization in Latin America (Nellis, 2000) does suggest, however, some (small) increases in inequality, surely in the short run, with the gains (efficiency and access to infrastructure) more diffused and over longer term. The experiences in the Bulgaria, Czech Republic, Russia and other transition economies show how a voucher scheme privatization scheme aimed at the general public can get high-jacked by insiders. Privatization currently underway in China, Vietnam and other countries is expected to lead to an increase in inequality. Again, the question is not so much whether reforms lead to an increase in inequality, but also whether that will undermine the institutional environment and support for reform.

These are only some examples of the perverse effects of financial liberalization and they do not make a general result. Furthermore, there are contrasting experiences, almost a necessity as we observe many now developed countries that had concentrated wealth structures and that have financial liberalized. Following a banking reform in the 1980s, French banks seem to tie their lending decisions more closely to firm performance as low quality firms that suffer negative shocks do not receive large increases in bank credit anymore, suggesting an end to soft-budget constraints due to more political credit allocation (Bertrand, Schoar, Thesmar, 2003). Public financial institutions in Brazil appear to have served disadvantaged groups more than private banks on some measures and for some services (Kumar et al. 2004). But these experiences with improved access are often not the general result in developing countries.

Rather liberalization seems to have often limited access to opportunities to few individuals and accordingly increased, rather than reduced economic inequality. If more liberalization leads to the expansion of stronger economic entities at the cost of weaker ones, financial reform can worsen the distribution of income and wealth even as it

improves average income or welfare. Or, even if inequality increases at first as a result of reforms and liberalization, it is not obvious by what mechanisms financial reform contributes to a subsequent diffusion of welfare and what initial conditions are favorable to “good” financial reform and which one are not.

Third: the sustainability of efforts. If inequality has the potential to undermine reform ex-ante, so is post-reform inequality likely to affect the sustainability of efforts ex-post. Reforms are more likely to be sustainable when they result in a greater diffusion of welfare, broadening the set of feasible economic opportunities for agents. Conversely, more limited diffusion of access to opportunities decreases the chances of success of reform, because when benefits are too concentrated, reforms can produce a political backlash. This would more likely be the case if they result in an increase in economic inequality, which further *reduces* the opportunities provided to a majority of individuals. Glaeser, Scheinkman and Shleifer (2002) argue that in many countries, the political response to institutional subversion by the rich was not institutional reform, but rather a turn to massive Robin Hood redistribution, often in the context of a social revolution. Such revolutions replaced the old oligarchies of the rich with new socialist or institutionalist oligarchies. In some cases, the massive redistribution that followed dramatically slowed economic and social progress. In other cases, the principal effect has been a change in elites, with continued capture of institutions by those in power.

Specific evidence on these ex-post political backlashes due to financial reform is rare, but the frequency of systemic financial crises following liberalization, precipitated by large capital outflows and causing large socialized losses, have especially discredited financial reforms for many observers. Capital account liberalization has actually been found to lead to subsequent de-democratization (Quinn, 2000). Rigobon and Rodrik (2004) report that trade openness has a negative impact on democracy.

Increased inequality need not lead to a backlash, however, if associated with a genuine diffusion of opportunities. In spite of rapidly increasing inequality, success for Central European businessmen has largely reflected their capacity to succeed in open competition

anchored by the desires to accede to the EU. Sustainability is an obvious need in a democracy, but also matters in other systems. Even while inequality has increased in some rapid growth countries (e.g., China), growth has mostly been driven by much new entry. In China, sufficient access to (informal forms of) finance and generally ease of entry have allowed new firms to take off, although politicians have typically captured some of the gains. A dual track approach, preserving the older parts of the economy, at least temporarily, may further mitigate concerns of the existing classes. Whenever the “powers in charge” realize that growth is key to their own survival, the political elites have also seen in rapid and broad based entry its chance of survival and thus limited the risk of excessively skewed wealth distribution. In Chile, especially following the 1979 financial crisis, the elite saw in reform the chance for survival (although mistakes were still made). In Singapore, admittedly a special case, economic growth has always been seen as the key to political stability.

The paths are thus not always clear, as transition economies’ experiences also show. In Russia, the diffused perception of a massive abuse of market reform under Yeltsin has led to a re-centralization of economic governance and punitive actions against some of the previous elite. Similar events happened in most of the Central Asian Republics and Belarus. Despite the progress in most of Central Europe, Slovakia is an example where, following a decade of slow reform in the financial sector and influence peddling, the pendulum only swung to reform as the date of possible EU-accession approached. More generally, the contrasting experiences of the eastern and western transition economies (the Great Divide discussed in Berglof and Bolton, 2000) show how fragile the outcomes, also in financial sector development, are to initial conditions. Yet Roland and Verdier (2001) attribute the relative success of the Central European countries to the constraints on abuses induced by the need to prepare for accession to the European Union.

Some experiences with financial reform and privatization show the benefits of broadening access and wealth distribution in terms of building constituencies for reform. Biais and Perotti (2002) argue that a deliberate diffusion of shareholdings during large-scale privatization has helped support for reforms, in countries as diverse as Chile, the

UK, France and the Czech Republic. In contrast, the experiences within Latin America and many transition economies generally have built little support, as the insiders reaped more of the gains. Nellis (2000) finds that the negative effects of privatization on inequality have had repercussions on public support for privatization and reform in Latin America. And in Russia, the process of privatization has undermined public opinion for reform as it led to high inequality. Reaching further back in time, Sokoloff (2000) explains part of the differences in institutions (and subsequent growth) between North and South America in the way land was allotted during periods of immigration.

Why, if there is this political backlash, do we still observe stalled or poorly designed reforms for long periods, especially in the financial sector? Some of it is the short-horizon of politicians. Failed banks, for example, are less likely to be taken over by the government or lose their license before elections than after (O'Neil Brown and Dinc, 2004). State-owned banks increase lending and lower lending margins in election years relative to private banks, while non-performing loans increase in such banks after the election (Dinc, 2003). In many cases, the elite finds the financial sector a good place to exercise control or plunder, something that can sustain itself over long periods of time. In finance, the costs and benefits may not be immediately observable and the processes are far from transparent. Many a times a financial crisis has benefited the elite in the run up to the crisis, in the crisis through looting, in the restructuring efforts, and in the post-crisis reform (by imposing restrictions), without attracting general public attention.

In Malaysia, although the final outcome may still have been beneficial, the imposition of capital controls has benefited the connected firms with ties to the ruling party (see Johnson and Mitton, 2003) that already earlier had large benefits that contributed to the causing the crisis in the first place. Capital controls created a screen for cronyism, in which the government forwarded resources to connected firms. Yet, the elite can still blame other factors, often shocks or foreign influences, for the crises. And, if any, the political economy feedback, can take considerable time. The backlash in Latin America against liberalization and privatization has taken a decade to materialize. This may reflect

the fact that even flawed reforms produced positive effects in the short-term, such as improved purchasing power, more consumer credit, and lower interest rates.

3. *Implications for financial reform, economic and political economy dimensions*

If inequality affects the degree of capture and sustainability of the reform process, by undermining the institutions needed to support a broad diffusion of benefits, how can developing countries, with their current high inequality, escape the trap? Does it make financial reform not feasible, or should financial reform take a different form? What other measures can help avoid regulatory capture and make reforms politically sustainable in the presence of inequality? The questions on what the links from inequality to financial reforms mean for reform can be seen as relating to four sub-questions:

1. the political economy of financial reform;
2. the form and speed of financial reform;
3. the links between financial and other reforms; and
4. the link with initial wealth and income distribution.

Political economy of financial reform. The degree of support for effective financial sector reform is a political economy question. The general political economy literature suggests that often-powerful groups have advocated financial reform, not the general public, suggesting that at least initially the reforms have benefited insiders more. The channels have often run through state interventions, given the large role of governments in the financial sector.

The experiences with financial sector reform until the early 1900s, at least until the Great Depression and World War II are especially worthwhile to recount, as they contrast in many ways with the current approach. The model for financial sector development

before the beginning of the 19th century was very much laissez-faire based.¹² Stock markets and private banks dominated the financial system; even central banks often evolved from private banks. The role of the state in managing the financial sector was often minimal. Financial systems had relatively free cross-border financial flows and international banks operated in many countries. This model was not without problems, as financial crises were frequent and economic costs high. Combined with only partially democratic environments, there was often a very unequal distribution of power and wealth, and financial access was certainly not available to all.

Yet, since the state was less involved in the financial system and international competition in capital flows often present (at least until World War I), there was less scope to use the public interests as argument for intervention. There was consequently less ability to use regulation as a vehicle to make outcomes to fit specific interests. In these environments, the mechanisms for control were clear: outright allocation of credit on an insider basis. Depending on the political system, the behavior was checked to some degree, and international competition provided a further check. And there were important differences, of course, among countries. In Germany, for example, more importance was given to state-owned banks to facilitate the mobilization of resources and to allow the industry to catch up with the UK. Wars also played important role as they involved the mobilization of vast resources and dictated a larger role for governments in the financial (and other) sectors.

While insider financing dominated, at the same time, in some countries, there were important shifts on policy triggered in part by broad public opinion. The most interesting episodes were large political shifts, which led to either a shift in the role for markets versus insiders or in the role of the state (and regulated intermediaries) versus capital markets. The first case is well represented by the strong political movement, which evolved against the concentration of financial power in the US in the first third of 1900s

¹² This model came about differently in each country. In the US, for example, there was first more control over the financial system but a number of political circumstances led to a period of free banking in the 1830s (see Bodenhorn, 2004).

(e.g., with the early antitrust regulation and the various commissions). This forced a widening of ownership control and concentration.¹³ This political attitude against concentration of power in the U.S has persisted (e.g., Roe 2003 on corporate governance reform), as exemplified by the reaction to the latest corporate governance scandals. No such strong and specific political motivated events occurred in most other developed countries, however.¹⁴ Rather, especially after the expansion of the electoral franchise after WWI, wealth accumulation through the corporate sector was often limited through taxation (especially inheritance) and social policies (see NBER papers on family-owned firms in Germany, Italy, Sweden and UK; Morck 2003 reviews).

The second case of a rapid increase in the role of the state is well represented by the post WWII experiences. While the variation among countries is large, starting with the great depression or following WWII, a much more top-down, state-oriented, financial system was pursued by many (now) developed countries, particularly in Europe. This post WWII model was exported to colonies and became the model followed by most developing countries following their independence. Since these countries had much weaker institutional environment, however, the so-called public interest was much misused through close links between private interests and political powers, with the two often coinciding. This describes well Mexico in the early 1990s (Haber and Kantor, 2004) and many other developing countries.¹⁵ A lesson would rather be to de-emphasize the role of the state not only in ownership, but also in many aspects of regulation and supervision, not only as the institutional capacity is weak, but also as regulation and supervision

¹³Cantillo (1995) describes the ownership and control of large railroad and industrial firms in the United States, previously largely controlled by salaried executives, was changed by massive corporate restructuring in the 1890s and 1990s. The firms became then controlled by banks such as J.P. Morgan. This was followed in 1914 by a public policy reaction to bank control (the Pujo hearings and Clayton Act), which resulted in an almost complete disappearance of active institutional investors from board of directors and a widening of ownership structures. He estimates that this political reaction destroyed about 6 percent of the equity value of bank-controlled firms.

¹⁴ In Japan, however, ownership was distributed more widely following WWII by the occupied forces, and concentration of ownership deliberately controlled during the US Administration.

¹⁵ Countries with relatively weak government/bureaucratic systems impose harsher regulatory restrictions on activities of banks, but systems have a higher probability of suffering a banking crisis (Barth, Caprio, Levine, 2003).

becomes a further pretext for political influences. It does not mean, however, that the first, laissez-fair model is necessarily better suited for developing countries.

At the country level, there are some lessons from when countries reformed their financial system. There is evidence that liberalization reforms tend to occur when no other options are left. Perotti and Laeven (2003) show that privatization programs are usually started during periods of fiscal and economic crises. Analysis on bank privatization suggests similar political economy dynamics. Boehmer, Nash, Netter (2003) shows that banks are actually privatized in developing countries when the system is worse, the government is more accountable and the more right-wing, while in developed countries privatization is more likely when the fiscal situation is worse. For Argentina and Brazil there is specific-evidence on politic links in bank privatization. Clarke et al. (2003) show that poor performance of Argentina's provincial banks was associated with greater likelihood of privatization. Large, overstaffed banks in provinces with high levels of both unemployment and public sector employment were less likely to be privatized. For Brazil, Beck et al. (2004) show that regional banks were only privatized when the costs to the local governments of continuing to use the banks for political purposes became too high (as the central government tightened regulation and supervision and lowered the public safety net). This evidence thus suggests that governments only reform when the costs of not doing so become too high (see Clarke, Cull and Shirley 2004 for a review of this literature).

There are also some political economy lessons from more recent financial reforms. In the US, changes such as the removal of intrastate banking restrictions or the repeal of the Glass-Steagall act were triggered by a mixture of plain lobbying, changes to the political system itself and economic forces. A sufficient degree of political accountability is probably necessary to ensure that legislators seek to spread its benefits.

The forms and speed of financial reform. Next, the speed of reform is important to consider. One of the lessons of recent reforms is that financial reform needs to be dynamically more balanced. Too often, financial reform is recommended as a radical

innovation, as it was indeed in case of the transition economies, but also in many developing countries. Rapid reform typically from the top down naturally concentrates decisions among top public officials and influential groups. A high speed of implementation furthermore leaves limited scope for public scrutiny and limited public learning of the implications of reforms, or of the emerging opportunities. Thus rapid liberalization may deliver too much discretion and considerable advantages for few, particularly those already in a position to capture areas previously restrained by regulation and segmentation. With high inequality and a poor institutional environment for scrutiny, rapid reform will thus be risky.

The recent experiences of rapid financial reform in Latin America, Asia and Eastern Europe and elsewhere suggest that these mechanisms will be at work. Too often, reforms were designed to initially co-opt entrenched interests, which subsequently blocked their effective implementation (for a powerful argumentation in favor of this channel, see Shleifer and Treisman, 2000). Often, the reforms seemed to move towards a market economy, but ended up with an even more distorted situation, at least for some time. Russia's choice of a universal banking system was not the result of a careful plan towards a market economy, but the outcome of bending to strong special interests, which wished to operate in an as unconstrained as possible manner. The loans for shares scheme, for example, was only feasible under the universal banking system, not under a separated system of commercial and investment banks, and it provided great rents to the insiders. This and other similar approaches often also led to regulatory capture, particularly when the rents granted to the special interests were so large as to assign enormous power of influence by special interests over the public sector. Other examples going back in history to reforms Europe and elsewhere are plentiful.

If any attempt at leapfrogging the intermediate stages of financial development is doomed to backfire in the presence of great inequality, the question arises whether a more gradual reform process is better. Roland (2000) has argued that gradual reform allows one to win over resistance to reform by allowing a strategic sequencing of reforms, thus allowing to

play different interest groups against each other. How to do, is tricky though, as it requires choosing the right sequence of reforms.

This may be even more difficult for financial sector reform where the system of checks and balances is less clear as transparency is less and objectives less clear. Here, lessons could be learned from more recent historical experiences of financial market development in developed countries in Europe and Asia (Japan). Following World War II, most of these countries had very interventionist economic policies, with large roles for the state. In the financial system, this involved many quantity restrictions, importantly a restrictive, segmented licensing policy for financial institutions. Even once entry was allowed, the financial system was kept highly segmented, with separate type of financial institutions offering distinct financial products (banking, insurance, capital markets, etc).

In principle, this type of system would be quite vulnerable to the influence of a few, powerful groups. There were counterbalancing forces, however, most importantly democratic governments and strong local participation, such as banks or even stock exchanges restricted to operate only in small areas (the US, for example, had banks limited to servicing a small community only (Jayaratne and Strahan, 1996, 1998), the UK had local stock exchanges, Frank and Mayer, 2004) and with restricted products. This rigid system was then slowly deregulated. Deregulation (removal of interest restrictions and lending/credit plans, lowering of barriers among products and markets, etc.), took place progressively, in part reflecting the speed at which indirect regulatory and market mechanisms became effective. These mechanisms included the establishment of reliable secondary markets, credible professional services such as auditing and rating agencies, and effective enforcement mechanisms such as bankruptcy. In some of these cases, even though the previous regulatory framework was inefficient and corrupt, these restrictions limited the scale, if not the scope, of misuses, including possible moral hazard. Of course, not all reform experiences were successful and banking and financial crises followed in some developed countries.

A lesson from these experiences could be that developing countries must evolve gradually to stages of greater financial development, following a natural sequencing. The obvious lesson, already much drawn, is that financial liberalization needs to be accompanied by institutionally strengthening, involving better regulation and supervision, etc. But this institutional capacity building takes time and the reform process itself needs to be adapted as well. Restrictions on competition can serve prudential purposes when the institutional capacity for enforcement is limited. Historically a valuable banking charter has been the best incentive to promote a long-term strategy of proper banking over short-term opportunistic speculation and theft.

Segmentation in particular represents a form of quantity restrictions that, while possibly unfairly applied, still may restrain the more egregious individual abuses. Segmentation imposes constraints that are crude but are very simple to verify, and can thus more easily and more credibly be enforced than price mechanisms can be verified (e.g., it is much more difficult to judge whether a loan for real estate is made at too generous terms than to see whether real estate loans are being made). Moreover, segmentation directed at existing local use of savings may ensure diffusion of access, especially if it is associated with institutions with more diffuse participation by the population (such as individually owned banks and insurance companies, or savings banks). Restrictions should be tempered, though, by some scope for potential entrants, although, subject to frequent reviews, and an openness to foreign investment.

Segmentation applies not only within the financial system, but also between informal and formal financial schemes. Segmentation of informal schemes can be valuable for several reasons. Moving informal schemes into the formal system risks overburdening them with regulation and supervision. It possibly also provides them with (implicit) access to government funds, thereby destroying their delicate incentive structures. Once they are formalized, arrangements may furthermore become more vulnerable to abuse by powerful interests. Valuable human capital may also leave too quickly the informal sector for the formal sector, thereby undermining the informal sector. Indeed, segmented forms of finance may well be the best option for many countries for long transition

periods. And, obviously, a more gradual process of liberalization allows the necessary build up in supervisory capacity of the central bank, supervisory agencies and other institutional mechanisms.

At the same time, a more gradual process may clearly become a recipe for inertia and capture, have serious static costs and not lead to market pressures for good institutional changes. The counterbalance will have to be specifics set in place to assign governance and scrutiny role for a broader population. To analyze the specific tradeoffs to the speed of reform, one can, at least conceptually, evaluate the effects of the type and sequence of deregulation, privatization, etc. on the ability and interest of different actors to adapt to, monitor and change the institutional environment. In privatization and corporate restructuring, an obvious precondition is a screening mechanism to separate firms of different quality and assuring that channels of finance for good and bad firms remain separate (Roland 1994). Simple examples in the financial sector at the micro-level include anticipating the to-be-expected drain of human capital from regulatory and supervisory agencies once a financial system gets liberalized, or the increased temptation to bribe officials, once only parts of the financial system gets liberalized. Capital account liberalization can undermine the incentives to invest in human capital (as argued by Bourguignon and Verdier, 2000a). Positive dynamic aspects include, for example, the market pressures for better regulation, supervision, and corporate governance once institutional investors are liberalized.¹⁶ Although the aspects to consider are many and the dynamics are hard to model and predict, it is nevertheless critical to do so to anticipate and guide policy reform. A model, as in China, can be to experiment with reform locally before extending the good reforms to the whole country.

The links between financial sector reforms and other reforms. If financial sector reform is difficult, are there other, more indirect ways to achieve the desired outcomes? One way

¹⁶ In addition, the effects of changes in regulation on financial institutions' and market participants' profitability and franchise value could be analyzed, and how that in turn may affect the ability and incentives to manage risk over time.

is through (accompanying) other economic reforms. The other way is through (accompanying) political economy reform.

Rajan and Zingales (2003) show the role of openness to trade and capital flows and competition in affecting the development of capital markets in Europe and the US in the early 1900s. Other supportive evidence on the links with openness is Faccio (2003) whom shows that economies in which the corporate and political elites have stronger blood ties also have more restrictions on cross-border capital flows. And Morck et al. (2000) show that economies with more inherited billionaire wealth as a fraction of GDP have more restrictions on inward foreign direct investment.

Trade competition is clearly a means to ease entry, making for larger growth opportunities and thus creating more demand for financial services. It can also be an indirect way to reveal misuses in the financial sector faster as it shows the less competitive sectors. Yet, openness to trade is not sufficient unless it is accompanied by the creation of some essential intermediate institutions that allow a greater number of productive units to benefit from participating. Openness to capital flows, freer entry in the financial and corporate sectors, and the ability of corporations to list in other financial markets affect the development of not only financial systems, but also of legal and regulatory systems. As noted, it is not clear in what sense these processes help or hurt financial reform, either indirectly through competition or income distributional effects. Some of these processes also affected by equality, e.g., access to international markets can be skewed towards certain segments of the economy at the costs of other segments.

While capital account liberalization is not necessarily the best indirect way to improve the quality of financial sector reform, there can still be a positive role of (official) international capital. Ex-ante, worse access to international financial markets can make for less reform hurting in the end the poor more. The rationale for official adjustment lending is in part based on ex-ante the “buying off” of some interest groups to accelerate

reforms and ex-post the smoothing of adjustment costs.¹⁷ The buying off and smoothing could be done by private markets as well, if the governments were benevolent and borrow accordingly, which they often are not. At the same time, we know that international private financial markets do not behave fully rational, are subject to overshooting and do not always consider the sustainability of reform efforts. Implications for official adjustment lending will thus vary among others with whether the country has access to international financial markets and whether it is using it productively. And how much governments want to use the commitment technology of international official lenders to assure reforms remain on track. A mix of capital account controls, to mitigate the perverse effects of financial integration, with some adjustment lending to accelerate reform can perhaps be “optimal”.

There are other reforms that can give agents “voice” over financial reform. In case of the removal of the intra- and interstate barriers in the United States, inter-industry competition and technology progress (i.e., changes in the form of financial services production) spurred politicians to remove the barriers. The emergence of non-bank financial institutions offering (near) banking services, for example, undermined the franchise value of banks. Better telecommunications allowed banks to easier reach consumers across markets, also reducing the franchise value of local banks. This reduced the political opposition to the removal of barriers.

In terms of the accompanying political reforms, there are clearly positive feedback effects between economic/financial and political reforms.¹⁸ Haber (1991) compares the evolution of the banking industries of Mexico and the United States from their independence to 1932. Although the initial conditions were similar: segmented monopolies were established that shared rents with the government and (at times) with public officials, the

¹⁷ This does not refer to short-term international liquidity support which rationale is based on the general economic adjustment costs due to a loss of liquidity.

¹⁸ For general reform, Giavezzi and Tabellini (2004) find first that the timing of events indicates that causality is more likely to run from political to economic liberalizations, rather than vice-versa (although they cannot rule out feedback effects in both directions). Second, the sequence of reforms matters, although evidence is more mixed here. They find that countries that first liberalize and then become democracies do much better than countries that pursue the opposite sequence, in almost all dimensions.

institutions that structured political competition, however, varied dramatically between the two cases. Institutionalized political competition undermined monopolies in the United States. In Mexico, on the other hand, the absence of institutionalized political competition allowed government-created banking monopolies to persist. The end results could not have been more different: even normalizing for GDP or population, Mexico had a smaller, more concentrated, and more inefficient banking system than did the U.S.

What seems most important is to enhance the scrutiny over the reform process. Countries with more open press, more accountable governments and more democratic can undertake faster and deeper reforms as the risks of capture are smaller. Dyck and Zingales (2002) show, for example, that an independent and free press mitigates theft by corporate insiders.¹⁹ And Perotti and Volpin (2004) show the link between enforcement and democracy. This suggests that institutional reforms achieving greater scrutiny are essential before embarking on drastic financial reform. A better-educated populace also presumably generates more pressures. Within the financial sector that may involve assuring before embarking on reform greater financial disclosure, more stringent accounting rules and auditing practices, better rules on conflicts of interest for regulators and supervisors, improving quality and pay of those involved in oversight, etc..

Affecting wealth and income distributions. Rajan and Zingales (2003) and Perotti-von Thadden (2004) stress the need for middle-class support for reforms, including financial sector reform, which helps challenge incumbents. Creating a middle-class is almost equivalent to resolving the development question, yet there can be particular wealth and income policies that (over time) help create constituency for support. The main possibilities are greater participation of citizens in capital markets, in education and in regulatory governance.

Diffusion of (direct) corporate sector ownership by the general public certainly affects their incentives to push for market reforms. There can thus be benefits of large-scale

¹⁹ However, Djankov et al. (2003) show that the media virtually everywhere are controlled either by the State or by a few wealthy families.

privatization programs, which in Western Europe and elsewhere in developed countries have broadened the distribution of equity ownership, and thus enhanced the desires for better governance and market reform. Broad distribution of shares requires, however, targeting and rationing of share allocations at IPOs to avoid immediate concentration of holdings. Granting stakes in former SOEs to pension funds also achieves a permanent participation. Such policies must be accompanied by empowering public opinion on matters of governance and supervision over the regulatory governance process, such that it becomes more open to public scrutiny and reduces the risk of capture. This requires more education of citizens on financial matters and the creation of intermediate institutions (not laws) empowered to question and demand disclosure, ahead of liberalization. In particular, empowering institutions to pursue transparency and disclosure requirements in a public and accountable way should precede liberalization. This is particularly relevant during the reform transition. Awareness of the fiscal consequences of failure also can add to more effective general scrutiny, limiting the socialization of risks and supporting the dissemination of the benefits. While popular involvement may delay the process, it may ensure its ultimate support. After all, the tax paying public often stands as the ultimate guarantor of solvency for the banking or pension system. Proper financial reforms should enhance financial access, improving opportunities for financially constrained but productive individuals. Financial broadening is essential for the stability of the reform process.

4. Conclusions and Policy Implications

The experiences reviewed in this paper suggest that the actual outcome from reform policies, whatever their content, are greatly affected by the distribution of political and economic power. Lack of political constraints and proper scrutiny can mean that regulatory measures are captured or circumnavigated by insider maneuvering (for some evidence that political institutions matter more than policy choices, see Acemoglu, Johnson, Robinson and Thaicharoen, 2002; for evidence that the quality of enforcement

has a direct impact on breadth of access to financial resources, see Perotti and Volpin, 2004).

A strong interpretation of this approach would be that there are no obvious good or bad policies, or better sequencing of reform steps. Policies do not matter if institutions fail to support a fair and reliable enforcement. And institutions do not matter if insiders can capture them. In such cases, policy goals may serve as fig leaves hiding capture by special interests, and well meaning technocrats and institutions end up holding the sack for the robbers. So what can be done to encourage change, without undermining the financial reform process? What are the policy implications?

In this final section, we seek to develop some policy implications. Their general spirit is that gradual reform and increasing accountability, i.e., the opening of the entire reform process to public scrutiny is the best means to limit opportunistic abuse of power by legislators, enforcers, or lobbyists on the part of powerful interests. Such transparency can be achieved by empowering representatives of social groups and organizations with the rights of intervention and scrutiny, although without providing any with veto powers. What this calls for is a general strategy of gradual institutional building aimed at limiting the risk of capture of the reform process. It involves a sequencing of institutional reforms ahead of actual financial liberalization, as well as the prioritizing of specific structural reforms aimed at limiting the consequences of opportunistic behavior during liberalization.

The broadening scrutiny on the regulatory framework should be considered ahead of the process of financial liberalization. It became common wisdom at the end of the 1990s that rules and supervisory institutions had to be set up along with the financial reform process. By now, it is realized that rulemaking is not institutional development. Rules do not ensure compliance, as they do not guarantee enforcement. Creating overambitious legislation has too often turned out to be a smokescreen for abuse. In fact, there has been an overemphasis on top-down liberalization of financial markets. While this has led to financial deepening, it has led to much capture.

Gradual reform

Ex-ante inequality of wealth and of political influence enhances the risk of capture of the financial reform process, and should thus act as a cautionary factor on the form and speed of financial liberalization. It is unwise to deregulate rapidly the financial sector in highly unequal countries, as this allows powerful groups to capture its design and influence supervisory institutions to their advantage. The risk is a distorted reform process, which enhances instability due to its inherent, deliberate flaws. Concentration of benefits and socialization of risks create the condition for reform failure and for a political backlash, which reinforces populist and nationalist views against globalization and liberalization.

For genuine financial sector development, the broadening of financial access is a necessity. We argue that to this purpose, a greater “democratization” of the regulatory framework and more generally a broadening of the representativeness of the institutional framework are also a necessity. Each liberalizing reform step needs to be preceded by institutional building that will create broader societal scrutiny and engagement with the process. Liberalizing reforms can proceed only at the speed at which these intermediate institutions dedicated to regulatory governance are created and become sustainable. Such institutions need to be nonpolitical and non-private consultation and monitoring mechanisms, which engage both technical personnel and members of the population called to represent users and taxpayers. Transparency must be ensured not (only) by requiring it by law, but by enabling civil society to be informed. Independent information institutions, such as independent media, nongovernmental entities, local authorities, trade associations balanced with customer associations can play this information dissemination role.

Such institutions must have a diverse composition and receive specific monitoring powers and budgetary resources that make them more autonomous from political interference or corruptive influences. Even if their task were largely consultative, they must have both powers and responsibilities to report the goals and status of reform

processes. In the end, creating such institutions means decentralizing political power to intermediate institutions with a social basis.

This approach has some resemblance to the so-called institutionalism approach (Olson, 1982; for a recent review see Roland, 2002). The main difference with our view is that this literature takes a very positive view of the political intent behind reform and focuses on normative questions, while we are concerned with the positive aspect of policy making. Yet there are valuable insights from this literature. Dewatripont and Roland (1995) and Roland (2000) have shown that in the presence of uncertainty over systemic reform outcomes, gradualism can be optimal. One reason is that it provides an option for experimentation, and thus adjustment, and in extreme case reversal, which reduce ex ante resistance to Pareto improving changes. A second argument is that it allows one to sequence reforms so as to divide opposition groups according to which have something to lose from some reforms and something to gain from others. While a gradual pace may delay reform, maintaining a steady pre-announced path offers potential beneficial pressures on enhancing the institutional environment.²⁰

Another useful argument arising from this literature is that gradual reform promotes checks and balances and allows some experimentation and competition in changes undertaken. An example is federalism (the US process of institutional changes has been called a “laboratory of states”). Regional experimentation has been also critical in the Chinese experience with liberalization, also in the financial sector. Yet, too much experimentation may lead to the involvement of too many groups in decision-making. This can create an excessive number of veto players, which may be stifling and prevent innovation (Olson, 1982). In the end, a balance has to be struck between a centralized top-down approach and the creation of more representative intermediate institutions.

While we call for gradual reforms, we do not adopt the traditional institutional view that it takes time to implement the right preconditions (e.g., having proper banking system

²⁰ There are of course complementary reforms to be taken simultaneously, for example, to prevent some agents from arbitraging between regulated and deregulated areas.

regulation and supervision before liberalizing). Certainly there are logistical needs to implement complex steps; this may include sophisticated tactical sequencing of reform steps to divide resistance and assure implementation (for a review of this thinking, see Roland, 2000). This approach is predicated, however, on the notion that politicians and policymakers are driven by appropriate incentives to build a proper reform framework, a view we contest. Any major reform process is naturally subject to lobbying, and given developing countries' high concentration of political and economic power, delay by itself will not allow proper institutions to emerge.

In fact, gradualism may turn into paralysis, while the allocative benefits associated with liberalization and privatization are lost. It is unacceptable to argue that the status quo cannot be improved. Maintaining tight regulations also supports capture by special interests or corrupt officials. In case of very weak institutional frameworks, tight political control over the economy is not much different from regulatory capture under liberalization. Even in less extreme institutional frameworks, state control entrenches powerful interests. Although it may limit the scope of appropriation by individuals, it allows insiders to target arbitrary benefits with politically influential individuals and social groups. In the end, economic growth requires a good balance of institutional development and empowerment of agents to explore new opportunities. As many have argued recently (e.g., Engermann and Sokoloff, 2000; see Rodrik, 2003 for a survey), there may be many institutional configurations, which lead to growth, but a major test for the quality of institutions is whether they are able to change as circumstances change.

In contrast, we seek a more positive than normative approach, by explicitly recognizing the non-contractible nature of control rights, the role of lobbying in decision-making, and the specific incentives of politicians. Sequencing is then based on building up social capacity to resist capture, with the goal of creating a greater institutional capacity to manage more complex reforms, as well as on undertaking concrete steps which can contain the potential downside risk of opportunistic behavior during the progression of liberalization. This thus involves sequencing the steps of financial liberalization with two

goals in mind: first, to build some safeguards against capture; and second, to defuse risks associated with greater discretionary behavior of agents under progressive liberalization.

Building safeguards

A fair reform process requires objective public attention, for two main reasons: first, public scrutiny aggregates information on the reform process as well as coordinates social response to limit capture; and second, it builds up confidence in the process, creating legitimacy that helps to justify the adjustment costs. Institutions that support public scrutiny include free media, a reliable judiciary, a competent and honest bureaucracy, and an educated middle class with some political voice. This is a forbidding list for many countries; these institutions are associated with developed democratic economies. Moreover, the complexity of financial services implies that objective scrutiny cannot be assured easily. What are then realistic recommendations for poorer, more unequal countries with unaccountable political systems, those most at need to build up their reform capacity and have better functioning financial systems?

Institution building, ahead or along side reform policies, needs to involve empowering existing or new “centers of specific interests” to participate in scrutinizing the process. This requires identifying non-state institutions, specifically social groups, which may be empowered to exercise some oversight over specific issues. Such institutions can include industry representatives, grassroots organizations, labor unions, media, local communities, consumer groups, NGOs, associations of smaller firms, or religious groups. Whom and how to empower is critical: the key to their effectiveness is some capacity to expose reform choices targeted to narrow interests. Their ability to resist lobbying pressures arise from the interests they represent, which should motivate them to contain abuse by special interests in policy design and implementation. In general, it is best to privilege groups whose interest lies in increasing access to productive opportunities, and thus containing excessive concentration of benefits to established producers and strong interests.

Granting any power to specific groups may create, however, as many difficulties as the disadvantages it may mend. Some precautionary considerations are therefore in order.

First of all, empowerment should follow some commitment in principle by the entity to general principles of liberalizing policy. Often market reforms are unpopular because they are expected to favor stronger over weaker social groups, not per se. Also it is clearly not optimal to grant blocking rights to any group, not just those which stand to lose the most from liberalizing reforms. Otherwise, this approach raises the risk of “counter reform capture”, so that empowered constituencies with interests at stake will seek to delay or block the process of reform. In extreme cases, coalitions can veto policies they know to be of social value because of uncertainty over the distribution of losses. An important strand of literature on reforms, starting with Alesina and Drazen (1992) and Fernandez and Rodrik (1992), blames the diffusion of veto power for costly delay in many countries in adopting valuable stabilization policies. This would argue that concentration of decision power on policymaking might be useful as it allows for valuable reforms. Yet this presumes that the policy choices promoted are socially efficient. When instead the policy process is expected to be captured and thereby to increase social costs and risks, some dispersion in power across different players will be useful. For some evidence on this in case of financial sector development, see Keefer (2001) on the effect of diffusion of power on the social costs of financial crises.

The best approach may be thus to identify a range of interest groups which may agree that some form of liberalizing reform would be desirable if it could increase access, and grant them consultation and intervention powers. These groups with partially conflicting interests would have incentives to scrutinize the process of reform and oversee the implementation process so as to target its benefits more broadly. No veto powers should be assigned to any one “institution” outside the government, so that no group would have the ability to block reform. Intervention rights would grant groups the right to demand relevant disclosure, with the obligation to diffuse such information, and to propose amendments. Particularly valuable would be to include representatives of groups which may benefit from increased access and a more reliable financial contracting environment, such as small enterprises, small investors and depositors. Such constituencies could have

the power to call for public debate on specific steps of the agenda. Ideally, all agents with interests at stake, including potential producers and foreign investors, should have access to this consultative process, provided they accept the spirit of the goal of broadening access from the outset.

This approach does not vindicate a classic class struggle vision of decision-making: it acknowledges that both socialist as well as more market oriented regimes are prone to favor specific constituencies. In some countries, the main forces aiming at policy capture may be the controlling shareholders of entrenched producers with the most to lose from entry by novel firms. Such producers in autocratic societies have often been natural examples of elites retarding economic renewal. Yet organized labor, while certainly a natural consultation party, may often not be the best counterbalancing group. Often, inside labor might also favor the status quo and block reform to protect their own position. Organized labor in many developing countries represents a relatively small fraction of the workforce, as many individuals work in the informal sector. The interests of a small inside labor sector are in fact likely to be aligned with the main shareholder interests in blocking reform, especially entry by new producers, or limiting the role of external investors.²¹ Indeed, the history of the emergence of labor unions in countries with dominant elites often is a story of co-optation of labor groups by producer interests (e.g. Haber et al, 2003 on Mexico). In many cases, granting voice to dispersed investors and new potential producers would create the most progressive block of interests interested in scrutinizing the process of policy design and the progress in its implementation.

²¹ In fact, the theoretical literature on political economy of finance has highlighted a likely coincidence of interests between large shareholders (inside capital) and workers in the formal sector (inside labor) to the detriment of more dispersed interests such as outside investors or consumers (Pagano and Volpin, forthcoming; Perotti and Von Thadden, 2004). The intuition is that an implicit alliance aimed at limiting external challenges to local producers generates rents that can be shared between insider capital and inside labor. This alliance can grant extensive control benefits to large shareholders at the cost of outside investors, supported by higher rents for inside labor. It creates however serious rigidities, which undermine promoting the most efficient producers, attracting external financial resources to fund entry, renewal and growth, and reallocating resources across sectors and producers.

In sum, there are clear risks to impose a consultative process to reforms, especially in political circumstances when individual governments have short time horizons. Yet there is not much gained by nominal “quick” reforms that undermine the very foundations of broader opportunities, which a fair market development aims to provide. We now turn to recommendations for the sequence of liberalizing steps in the financial system.

Defusing risks ahead and along the reform process

While the balance struck will have to be country specific, there can be some specific recommendations for the sequence of liberalizing steps in the financial system. One recommendation is experimenting with loosening control over less vulnerable aspects of the financial systems first, in particular focusing on steps to broaden the foundation of the system before seeking to deepen it. The logic behind this argument is that broader involvement in the reform process by potential beneficiaries as well as potential losers helps limiting capture by narrow interests and build up support. Related recommendation is that the reform process has a better chance to succeed by postponing the liberalization of those segments where the greatest damage may be done by opportunistic behavior.

What does this means in practice? It involves limiting the potential for abuse by first broadening the least sophisticated but fundamental basis of a financial system. The development of an infrastructure which favors expanding access to financial services and capital should take priority over promoting complex reforms for more sophisticated transactions, such as stock markets. One can envision the financial system as a pyramid of increasingly complex transactions and decreasing access. At the basis of the pyramid is the basic payment system. Expanding its reach and reducing its cost should be a priority in many countries; the experience with foreign remittance in many countries has highlighted the high costs of basic transfers and the limited involvement of the formal sector in this function.

Next come safekeeping of precautionary savings, which certainly includes maintaining nonnegative interest rates; it may also include protective measures aimed at the segmentation of deposit banks, or tight restrictions on concentration of risk for deposit taking institutions.²² Next come allowing for relatively safe loans, such as government debt and collateralized loans, and perhaps simple forms of consumer finance. Next come large commercial loans. At the top of the pyramid are organized exchanges and trading systems, too often prioritized at the cost of neglecting less sophisticated but more broadly accessible forms of financial transactions.

²² This may be implemented as a temporary orientation to narrow banking for banks, which aim at having some form of deposit insurance. It does not need to come at the cost of greater risk taking by some other non-deposit taking financial institutions, such as finance companies or investment banks which are willing to operate outside any deposit insurance scheme.

In some cases, expanding some type of financial services may require limiting initially the degree of competition in these segments, both across institutions and geographically, while committing to relaxing it over time. Such an approach can attract more investment by financial institutions otherwise drawn to larger transactions with higher margins (or greater lobbying pressure). And it can insulate at early stages the deposit market from the potential for opportunistic abuse by insiders. Of course, any competition-limiting approach requires heightened attention to opening the process of governance over lending policies.

In this sense, segmentation has some feature of “quantity regulation” which, as Glaser and Shleifer (2000) argue, offers greater resistance to manipulation than more sophisticated regulatory approach. Liberalization that relies on advanced supervisory activities by governments typical of developed countries demands too complex enforcement, is untransparent to a broader audience and thus allows greater discretionary choices by enforcers and regulators, all reasons why such reforms are at high risk of capture by lobbying interests in developing countries. Cruder measures may be more effectively used to contain large-scale risk taking and fraud, and should only be relaxed once the regulatory system improves its effectiveness.

There are other steps, which may be taken ahead of major liberalization steps, and these are aimed at increasing the capacity of regulators to resist demands by special interests. A specific example to be taken ahead of liberalization is to limit the influence of specific groups or families over bank governance. Typically, financial crises have been most severe in countries where banks are controlled by large shareholders (or by the state). A requirement that banks subject to more relaxed rules have a more diffused ownership structure, and perhaps a significant share of foreign investors, seems an essential precondition to expand their freedom of action. Another possible step is to invest in a medium term training program for a larger cohort of younger functionaries not obviously taken from the elite. The program should be built to ensure that they will be contractually committed to return to work in the public sector for a sustained period afterwards, so that

it is possible to avoid a classic debacle in many reforming countries, where the most competent public officials leave soon after the begin of reform to join large private firms.

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