

DEMOCRACY, ELITE BIAS, AND FINANCIAL DEVELOPMENT IN LATIN AMERICA

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INTRODUCTION

What explains financial development? Why are some countries more likely to liberalize their financial systems by reducing barriers to entry into the financial services sector and allowing market mechanisms to govern the supply and price of capital? Why are some more likely to promote transparency, protect property rights, and enforce contracts in ways that promote efficient financial intermediation?

These questions matter greatly. The immediate consequence of financial development is a ready supply of capital at reduced cost that matches the demand for it. The ultimate outcome is consistent economic growth.¹ Specifically, a large, sophisticated financial sector in which capital is readily available and allowed to flow to its most productive uses has been linked to long-term development through several mechanisms that include the accumulation of productive factors and increased productivity.² Moreover, financial development expands the economic opportunities of disadvantaged groups and reduces persistent inequality.³ Improved access to low-cost capital allows entrepreneurs to enter markets they would otherwise be excluded from because of their inability to finance innovation and supply chains.⁴

*Victor Menaldo would like to thank Stephen Haber for his entire body of work on the link between institutions and finance, and for countless conversations about finance, regime types, and methodology. This article would not have been possible without access to either of these resources. Daniel Yoo would like to thank Margaret Levi and Yoram Barzel for their comments on earlier versions of this article. The authors take full responsibility for any errors.

¹ Beck, Levine, and Loayza 2000; Fisman and Love 2003; King and Levine 1993; Rajan and Zingales 1998; Levine, Loayza, and Beck 2000; Arcand et al. 2012. Although, see Cecchetti and Kharroubi 2012, who argue that increases in financial development at the highest levels of financial depth reduce growth.

² For an exhaustive list see Becerra, Cavallo, and Scartascini 2012, 626.

³ Demirgüç-Kunt and Levine 2009.

⁴ Banerjee et al. 2013.

World Politics, 1–34

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doi: 10.1017/S0043887115000192

One theoretically compelling answer to the question of what determines financial development is regime type. For mutually reinforcing reasons, democracies should have larger and more sophisticated financial systems than nondemocracies.⁵ On the one hand, there is a powerful demand-side reason for this: the majority of the population benefits from access to formal banking and reliable and cheap credit. On the other hand, there is an elegant supply-side reason: elected officials face systematic incentives to provide the legal, administrative, and political infrastructure needed to underpin the transactions that make access to affordable finance possible. These incentives are the result of increased political competition and the checks and balances associated with democratic governments.

The empirical evidence that supports these contentions has nevertheless been the subject of considerable debate. Some researchers have uncovered evidence that purports to show that democracy promotes financial development. Focusing attention on developed Western countries, Michael Bordo and Peter Rousseau find that more frequent elections and female enfranchisement are correlated with larger financial sectors.⁶ Broadening the analysis to include developing countries, Philip Keefer finds that the number of continuous years of competitive elections is a significant determinant of financial sector development.⁷ Similarly, Sourafel Girma and Anja Shortland find that autocracies are less likely than democracies to establish financial markets, and even if they do, financial development is not likely to follow.⁸

There is also reason to be skeptical that democracy is tantamount to financial development. Benhua Yang finds that in a panel of developing and developed countries, once country fixed effects are controlled for, the positive relationship between democracy and financial development disappears.⁹ Yongfu Huang notes that democratic transitions are

⁵ See Barth, Caprio, and Levine 2006; Bordo and Rousseau 2006; Keefer 2007; Quintyn and Verdier 2010; Haber, North, and Weingast 2008; Calomiris and Haber 2014.

⁶ Bordo and Rousseau 2006.

⁷ Keefer 2008.

⁸ Girma and Shortland 2008. One might also argue that the “factor endowment” paradigm confirms the democracy-finance nexus. Acemoğlu, Johnson, and Robinson 2001 show that exogenous differences in disease environments due to climate in former European colonies explain contemporary differences in the political institutions associated with financial development, a finding that has been extended by Beck, Demirgüç-Kunt, and Levine 2003 to account for financial outcomes themselves. But the problem with instrumenting political institutions with time-invariant factor endowments and similar legacies, as Rajan and Zingales 2003 point out, is that levels of financial development have varied widely within countries over time, and one cannot explain a time-varying phenomenon with a factor that is a constant. Although Rajan and Zingales 2003 advance this point to undermine the legal origins view of finance, in which common law is purported to be better for financial development than civil law (see La Porta et al. 1998), it also applies to the factor endowments view.

⁹ Yang 2011.

typically followed only by a short-lived boost in financial development.¹⁰ And focusing attention on former communist countries, Nauro Campos and Fabrizio Coricelli find that financial development fails to take off in the first years after democratization.¹¹

To help reconcile these contrasting findings, we introduce and test a theory that advances a conditional relationship between regime type and finance. It explains why pressure for financial reforms to benefit the majority translates into financial development only in some democracies. Democracies in which the median voter has a strong hand in writing the rules of the game, which we proxy for with the adoption of their own constitution after transition, enact financial policies that benefit the majority by increasing the supply of capital and reducing its price. Specifically, these “popular democracies” should be more likely to liberalize their financial systems, provide greater access to banking, supply more credit, and have larger stock markets. By contrast, democracies in which the elite have imposed these rules, which we proxy for with the adoption of a constitution inherited from the previous autocracy, should exhibit contrary policies and outcomes. In those democracies, oligarchs can stifle the growth of the financial sector to maximize rents via barriers to entry into the financial system that rations capital.¹²

Empirically, we focus on Latin America and Caribbean countries (henceforth, LATAM) and do so for three reasons. First, there have been several drastic historical changes in the financial systems in that region. Brazil, for example, experienced a dramatic reversal at the turn of the twentieth century, in which a vibrant financial market was replaced by severe financial repression.¹³ And while LATAM was populated by some of the most financially repressed places on earth up until the mid-1980s, the general pattern has been financial liberalization across the region since then, especially after painful bouts of structural adjustment and the dissemination of a neoliberal policy agenda.¹⁴ Yet progress has been uneven: only a few LATAM countries have truly developed financially. Second, we can conduct several before-and-after comparisons of the effects of regime transitions in this region because it has experienced frequent cycling between political systems. Third, we expect not only a change toward greater promajoritarian policy after the

¹⁰ Huang 2010.

¹¹ Campos and Coricelli 2009.

¹² This idea is consistent with that of Becerra, Cavallo, and Scartascini 2012.

¹³ See Musacchio 2009.

¹⁴ Montenegro 1997, 28.

establishment of popular democracy in LATAM, but also that the magnitude of the effect will be quite large, given that Latin American countries are considerably unequal. These countries' high levels of asset and income inequality mean that the median voter is relatively poor, and thus the demand for greater access to consumption and investment opportunities, which are afforded by more and cheaper credit, is relatively high.

Our theory is corroborated through the use of an original panel data set that identifies the constitutional legacy of LATAM's numerous post-World War II democratic experiments. We code institutional arrangements that range from majoritarian democracy to elite-biased democracy. Our results hold across several measures of financial development. They are robust to a host of potential alternative explanations, the inclusion of country fixed effects, year fixed effects, country-specific time trends, and instrumental variables estimations. We also explore the particular constitutional features that inhibit financial development under democracy, such as the banning of left-wing parties. The financial repression practiced by elite-biased democracies in LATAM reconciles the fact that region-wide democratizations since the 1970s have often failed to promote development.

THE POLITICAL ECONOMY OF FINANCE

THE DEMAND FOR FINANCIAL DEVELOPMENT

The median voter—and hence the majority—wants redistribution and greater economic opportunities.¹⁵ Therefore, the median voter desires access to a sizable quantity of credit at low interest rates that does not require too much collateral.¹⁶ Such credit unleashes more consumption and investment opportunities.¹⁷ Without access to credit, poor individuals usually cannot afford to pay up front for their homes, consumer durables, higher education, and job training.¹⁸

¹⁵ See Acemoglu and Robinson 2006.

¹⁶ Hoffman, Posten-Vinay, and Rosenthal 2007.

¹⁷ See Galor and Moav 2004.

¹⁸ See Karlan and Zinman 2010. To be sure, the median voter's preferences for access to credit may, ironically, create room for a possible trade-off between conventional transfers and financial development. Politicians might face incentives to deploy credit to fend off redistributive demands. See Ahlquist and Ansell 2014. Even if the greater availability of credit may partially substitute for welfare spending in a democracy, however, the former is unlikely to fully crowd out the latter. Providing greater access to economic opportunities for those who lack savings or are not politically connected ultimately calls for creating a more sophisticated financial system, no matter the strength of the social safety net. See Greenwood and Jovanovic 1990; and Demirgüç-Kunt and Levine 2009.

The development of a country's financial sector entails greater access to financial services. Such access is accomplished by expanding the supply and reducing the price of banking and credit. The existence of a larger number of financial intermediaries involved in channeling savings to investments, in a process priced by market mechanisms, makes credit more widely available and cheaper. Increased competition between banks reduces the spread between the interest charged for loans and the interest earned on savings. Therefore, the majority of the population should prefer banking liberalization.

The median voter should also desire strong asset markets. Vibrant stock markets are a natural, albeit more sophisticated, extension of a strong banking system.¹⁹ For this reason, Enrico Perotti and Ernst-Ludwig von Thadden developed a formal model that avers that the median voter will tend to support stock markets when the expected rates of return on equity warrant it, although that voter will show greater support for bank finance if he or she relies on labor income alone or if pension systems are not capitalized.²⁰ Similarly, it has been argued that because capital markets constitute an arms-length source of finance par excellence, they should be supported by the majority if the majority fears that the banking system can be captured by oligarchs, thus rendering it relationship-based.²¹ In addition, Philip Hoffman, Gilles Postel-Vinay, and Jean-Laurent Rosenthal argue that the middle class, in particular, will favor securities markets and financial innovation because both reduce the cost of capital by increasing competition and diversification.²²

THE SUPPLY OF FINANCIAL DEVELOPMENT

Policymakers can engage several levers to generate financial development. The bank chartering process can be liberalized and bank branching allowed, thereby lowering barriers to entry and forcing banks to compete for deposits and over loans. This competition should broaden the supply of credit and reduce the margins in financial services, thus reducing the price of capital. Improved contract enforcement, the creation of property registers, and modern bankruptcy law may incentivize banks to loan more money since they will be able to repossess collateral in the case of default.²³ Modern accounting standards and greater access to information transparency also matters; these measures mitigate

¹⁹ See Haber, Razo, and Maurer 2003, 81–82; and Haber, North, and Weingast 2008.

²⁰ Perotti and Thadden 2006.

²¹ Girma and Shortland 2008, 575.

²² Hoffman, Postel-Vinay, and Rosenthal 2007, 85.

²³ Haber, North, and Weingast 2008 and Calomiris and Haber 2014 discuss these ideas.

information asymmetries, allowing depositors and investors to better assess risk and trust the integrity of bank lending. Moreover, more reliable credit monitoring, rating, and reporting induce banks to lend money to a greater number of debtors by reducing the problems of adverse selection and moral hazard.

Legislation that might induce the growth of stock markets is similar. Stephen Haber, Douglass North, and Barry Weingast, and Hoffman, Postel-Vinay, and Rosenthal outline some relevant policies.²⁴ In general, greater property-rights security and more reliable and impartial contract enforcement is a boon for a stock market. More concrete reforms that would precipitate the growth of a stock market include policies that promote stronger corporate governance, which in turn might facilitate risk taking and reduce informational asymmetries and transaction costs. Some examples are the compulsion of firms to maximize profits, limited liability, and corporate bankruptcy laws in which firms' liabilities can adversely affect a purchaser only to the extent of the share price. Other examples include sounder accounting standards and regulations that promote transparency, such as mandatory disclosure, and laws that make it illegal to engage in insider trading.

For finance to be readily available and efficiently allocated, the incentives of those writing the financial conventions must be aligned with the incentives of those who benefit from allocating capital to its best use. If these incentives are aligned, institutions should function on behalf of the majority of the population. In other words, they should favor those individuals who are more likely to be entrepreneurs, less likely to finance investments by recycling profits, and more likely to need to smooth consumption.

REGIME TYPES AND FINANCIAL DEVELOPMENT

In theory, democracy should be that incentive-aligning mechanism. It putatively allows for the majority to express its preference for financial services politically and for politicians to respond accordingly. Democracy potentially strengthens the political voice of individuals who lack the assets and profits necessary to finance investments in physical and human capital and to smooth consumption. It stands to reason that politicians respond to these demands if they wish to win and retain office.

To explain why some democracies have cultivated large sophisticated financial systems while others have not, it is necessary to unpack

²⁴ Haber, North, and Weingast 2008; Hoffman, Postel-Vinay, and Rosenthal 2007.

democracy—specifically, to identify whether the median voter is able to influence economic policy or whether a smaller subset of the population, the economic elite, has the power to write the rules of the game. If it is the latter, and the economic elite can monopolize the rules of the game after democratization, usually by imposing their own constitution, then policymakers may not have incentives to make credit widely available at a reduced price.

FINANCE IN ELITE-BIASED DEMOCRACIES

An elite-biased democracy is one in which the economic elite strategically shape a new democracy's institutions to promote policies biased in their favor.²⁵ It often entails institutions that enshrine laws and policies opposed to those preferred by the majority of the population. The elite can adopt rules that lead to the institutional overrepresentation of their interests and that tie the hands of would-be populists who seek to win electoral support by redistributing or by reforming the economy in ways that undermine the elite's rents. The latter includes liberalizing the financial sector.

There are several ways in which the elite can codify their preferences. They can codify proscriptions against socialist parties and other left-wing organizations, such as labor unions. They can maximize the effect of cross-cutting cleavages by creating multiple veto points that vouchsafe the interests of wealthholders. This includes holding indirect elections for the executive branch, such as through an electoral college. It can include imposing a bicameral legislature. And it might entail enshrining clauses that call for appointing senators with conservative persuasions, such as military officers.²⁶

When a small group of elite runs a democracy and controls its economy, in part by exploiting the aforementioned constitutional tools, it may have fewer incentives to generate large and efficient financial systems. It might instead choose to curtail the supply and allocation of capital. The elite may benefit from the politicized creation of rents associated with erecting barriers to entry to the supply of capital. To achieve this end, policymakers may ration bank charters and award them to political insiders who can then artificially ration credit to widen the

²⁵ The elite are a small segment of the population that enjoys a disproportionate share of economic and/or political power. It is a simplifying assumption consistent with Acemoglu and Robinson 2006, although there is certainly heterogeneity within this group in practice. Rajan and Zingales 2003 refer to this group as incumbents in the financial sector and in industry.

²⁶ This is not an exhaustive list. Other tools include malapportionment that overrepresents the rural elite, for example. See Albertus and Menaldo 2014a and Albertus and Menaldo 2014b for a discussion of this and other measures.

spread between the interest rates they pay on savings deposits and what they charge for business and consumer loans.²⁷

The elite may also benefit from the politicizing of credit in indirect ways if it earns rents from protected firms or subsidized industries. It may favor the creation of agencies and practices that channel bank lending at subsidized rates to protected sectors and use financial repression to accomplish this task. Policymakers may turn to tools like extremely high reserve requirements on ordinary lending coupled with subsidized loans and compulsory investments—either directed by the central bank or the public treasury or forced upon commercial banks—to favored sectors or the outright nationalization of the banking system. While the ostensible reason for this type of directed credit may be to advance development objectives or protect strategic sectors, this is a tool often used to prop up politically influential firms.²⁸

POPULAR DEMOCRACY

Democracy biased toward the elite, however, clearly does not always obtain. While an elite-friendly democracy may be expected to be better for the economic elite than more uncertain autocratic rule, the elite cannot always manipulate the timing and circumstances of a democratic transition. Unexpected moments of elite weakness may elicit pressure for democratization, leading to a transition *despite* the inability of the elite to guarantee a credible commitment to its rights and interests under democracy. In cases in which the elite are caught off balance, they are pressured to rush into a transition bargain more quickly than they would otherwise have done, thus reducing their ability to manipulate the transition process to safeguard their interests after democratization.

Examples of democratic consolidation amid elite weakness are of two types. First, they comprise transitions that occur when an incoming democratic regime overturns the old order by writing a new constitution that empowers the majority and sidelines erstwhile oligarchs. Second, they comprise extant democracies that, at some point after a transition, find a way to rewrite the social contract to favor popular sectors. In both cases, democracies will tend to adopt economic

²⁷ A reduction in the barriers to entry to the supply of credit not only reduces the spread on interest rates, the primary source of profit for financial institutions, but also undermines other privileges: established lending relationships among the elite and human capital premiums earned by the elite. Petersen and Rajan 1995; Rajan and Zingales 2003.

²⁸ See Haber, Razo, and Maurer 2003. An exception to this general rule might be if capitalists benefit from the aggregate accumulation of human capital. In this case, the returns to the elite might depend on ameliorating capital market imperfections that prevent the poor from borrowing to finance education. Galor and Moav 2006.

policies that favor the median voter, including ones that regulate finance to make it more readily available and cheaper.

MAIN HYPOTHESES

The theory detailed above posits that there are scope conditions that explain why some democracies promote financial development—relatively large and sophisticated credit and capital markets—whereas others do not. The legacy of the transition to democracy influences the relative power of the elite versus the masses after democratization. It therefore predicts whether economic policies will be promajoritarian or elite biased. We expect to see a reduction in the barriers to entry into the financial sector and a concomitant increase in the size of credit and capital markets after democratization *only* when the new democracy follows a transition process in which the elite is weak.

Here we explain the various financial outcomes predicted by the theory in the sequence in which they should unfold. First, although popular democracies should be more likely to reduce the barriers to entry into the financial services sector, elite-biased democracies should be less likely to do so. Liberalizing the bank charter process and reducing the spread between savings rates and interest rates on consumer loans—thus reducing the rents earned by banks—should result in greater liquidity.²⁹ Second, popular democracies should cultivate larger banking sectors because of liberalization and because they should be better than elite-biased democracies at protecting property rights and enforcing contracts for a larger share of the population. They should be more likely to enforce property rights to collateral, abstain from expropriating liquid assets, refrain from forgiving the debt of influential borrowers, and enact prudential financial regulation. Third, and by extension, because market mechanisms should guide the allocation of capital, the availability of private credit will be greater in popular democracies. Fourth, and similarly, stock markets should be larger in popular democracies as well. Fifth, one of the chief mechanisms by which popular democracies will usher in a greater volume of capital at a reduced price in Latin America in particular should be through financial reforms that reduce entry barriers, privatize the banking system, and promote the growth of securities markets. In the sections below, we empirically explore these hypotheses and some ancillary implications.

²⁹ Greater liquidity means that a larger number of transactions are settled with the same number of funds transferred.

RESEARCH DESIGN

We evaluate the empirical implications by generating an original time-series, cross-section LATAM data set that observes twenty-two countries between 1965 and 2006: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela, Jamaica, Trinidad and Tobago, and Guyana.

DEPENDENT VARIABLES: MEASURING FINANCIAL DEVELOPMENT

Here we explain how we measure the dependent variables that operationalize financial development. We also disclose their relevant summary statistics. The first four variables are from Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, and except for the last one, whose coverage begins in 1989, they are available from 1965.³⁰ We discuss the sources and coverage for the fifth variable last.

Liquidity is measured as liquid liabilities (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) as a percentage of gross domestic product (GDP). This variable captures financial depth: the size of the financial intermediary sector relative to the economy. There are 814 observations. The mean is 29.41, the standard deviation is 13.82, the minimum is 5.41, and the maximum is 91.83.

Total deposits is measured as demand, time, and saving deposits in deposit money banks and other financial institutions as a percentage of GDP. It is a generic measure of banking sector development. There are 844 observations. The mean is 24.04, the standard deviation is 13.68, the minimum is 2.01, and the maximum is 83.08.

Private credit is measured as credit issued by deposit money banks as a percentage of GDP. It is perhaps the most common measure of financial development and indicates the ability of financial intermediaries to mobilize savings, allocate resources, and conduct exchanges. There are 844 observations. The mean is 23.27, the standard deviation is 13.90, the minimum is 1.82, and the maximum is 97.32.

Stock market capitalization measures the size of the stock market qua the value of listed shares as a percentage of GDP. This variable captures how developed and sophisticated the equity market is. There are 250 observations. The mean is 24.22, the standard deviation is 26.12, the minimum is .46, and the maximum is 122.81.

³⁰ Beck, Demirgüç-Kunt, and Levine 2010.

Last, *financial reforms* is an index of financial system liberalization. It has coverage from 1973 onward. To construct this variable we use data from Abdul Abiad, Enrica Detragaiache, and Thierry Tressel.³¹ We add together three financial liberalization variables from that data set to create an ordinal measure that varies from 0 to 9, with higher values denoting greater liberalization.³² The first component is the reduction in barriers to entry in the financial sector. The second is the privatization of banking, and the third is policies promoting the development of securities markets. *Financial reforms* comprises 561 observations. The mean is 3.73, the standard deviation is 2.74, the minimum is 0, and the maximum is 9.

INDEPENDENT VARIABLES

Across the models that are reported and discussed below, we include three key independent variables: *regime type*, *democracy with autocratic constitution*, and *democracy amends autocratic constitution*.

Constructing *democracy with autocratic constitution* and *democracy amends autocratic constitution* requires us to first decide what counts as a regime transition. We use the binary, electoral version of regime type provided by José Antonio Cheibub, Jennifer Gandhi, and James Vreeland.³³ A country is coded democratic if the chief executive and legislature are elected, there is more than one political party, and there is political alternation.

Democracy with autocratic constitution captures whether a democracy is elite biased or not. It is coded as 1 when a democracy operates according to a constitution inherited from the previous authoritarian period. It is coded as 0 if the constitution is a democratic constitution in place before the previous period of dictatorship or if the democracy passes a new constitution sometime after democratization.³⁴ Since we seek to examine how the conditions under which countries democratized affect their subsequent financial development, elite weakness on the eve of transition is a legacy variable.

Popular democracy is the obverse of elite-biased democracy. A democracy is considered as operating under a democratic constitution—and is thus a popular one—if the following conditions hold. It either creates a new constitution upon democratization; operates according

³¹ Abiad, Detragaiache, and Tressel 2008.

³² The original measures in Abiad, Detragaiache, and Tressel 2008 vary from 0 to 3. Each is coded as 3, fully liberalized; 2, largely liberalized; 1, partially liberalized; or 0, heavily regulated.

³³ Cheibub, Gandhi, and Vreeland 2010.

³⁴ The coding switches to “democratic constitution” starting the year of annulment.

to a prior democratic constitution that was in place before the previous period of dictatorship; passes a new constitution sometime after democratization; or amends an autocratic constitution adopted on the eve of democratization. This means that we must also operationalize a variable called *democracy amends autocratic constitution*. It is coded as 1 if a democracy amends an autocratic constitution that it had previously inherited and 0 otherwise.

Table 1 identifies all the instances of democracy in LATAM since 1950, whether the democracy inherited a constitution from the previous autocracy, and the most important constitutional impediments to majoritarianism associated with these elite-biased charters.³⁵ Specifically, the table outlines which constitutions prescribed executive elections through indirect means, such as unelected electoral colleges or the legislature, bicameralism, the appointment of senators opposed to populist policies, and the banning of left-wing parties. The table reports more than thirty transitions to democracy since 1950. It also reveals that 71 percent of democracies that transitioned during this time (twenty-two out of thirty-one) were elite biased—although several of these regimes annulled their autocratic constitutions at some subsequent point.³⁶

CONTROL VARIABLES

For ease of exposition, we focus our analysis on covariates that are also linked to policies preferred by the median voter under democracy. Those variables are the most likely to be correlated with our measures of popular and elite-biased democracy. We note that the results across the regression tables are robust to the inclusion of a host of macroeconomic policies and outcomes. These include the degree of capital account liberalization, for example. They are also robust to controlling for the sectoral composition of the economy, party ideology, and the role of the International Monetary Fund (IMF).³⁷ Because the main results do not really change when these other controls are included and because their effect on the outcomes of interest tends to be negligible, we omit these regressions from this article.³⁸

³⁵ Several primary and secondary sources were used to identify these parameters. Chief among them is Elkins, Ginsburg, and Melton 2010, which codes the formal characteristics of written constitutions for independent states since 1789.

³⁶ Brazil, Colombia, Ecuador, Paraguay, and Venezuela annulled their autocratic constitutions several years after their democratization.

³⁷ Sectoral composition is operationalized as the share of the economy represented by manufacturing; party ideology is operationalized using *EXECRLC*, from Beck et al. 2001. This variable codes whether the executive branch is controlled by right-wing parties versus centrist parties versus left-wing parties. The role of the IMF is a dichotomous measure of whether or not a country has adopted an IMF standby agreement, and is from Chwieroth 2007.

³⁸ They are available upon request.

TABLE 1
 CONSTITUTIONAL ENGINEERING UNDER LATIN AMERICAN AUTOCRACIES,
 1950–2006^a

<i>Country</i>	<i>Democratic Transition Year</i>	<i>Autocratic Constitution^b</i>	<i>Elite-Biased Measures</i>
Argentina	1958	yes	bicameralism, indirect elections
Argentina	1963	yes	bicameralism, indirect elections
Argentina	1973	yes	bicameralism, indirect elections
Argentina	1983	no	
Bolivia	1979	yes	
Bolivia	1982	yes	
Brazil	1979	yes (1988)	bicameralism, indirect elections, left-wing parties banned
Chile	1990	yes	bicameralism, appointed senators, left-wing parties banned
Colombia	1958	yes (1991)	bicameralism, left-wing parties banned
Dominican Republic	1966	no	
Ecuador	1979	yes (1984)	bicameralism
Ecuador	2002	no	
El Salvador	1984	yes	left-wing parties banned
Guatemala	1958	yes	left-wing parties banned
Guatemala	1966	yes	left-wing parties banned
Guatemala	1986	no	
Honduras	1957	no	
Honduras	1971	yes	indirect elections
Honduras	1982	no	
Jamaica	1962	no	
Mexico	2000	yes	bicameralism
Nicaragua	1984	no	
Panama	1952	yes	
Panama	1989	yes	
Paraguay	1989	yes (1992)	bicameralism, appointed senators
Peru	1956	yes	bicameralism
Peru	1963	yes	bicameralism
Peru	1980	yes	bicameralism, appointed senators
Peru	2001	yes	bicameralism
Uruguay	1985	no	
Venezuela	1959	yes (1961)	bicameralism, indirect elections

^a Table includes all cases of democratic transitions in Latin America from 1950 to 2008 as coded by Cheibub, Gandhi, and Vreeland 2010.

^b Autocratic constitution adopted prior to democratic transition. Year of annulment following a transition is in parentheses. The Peruvian Senate was eliminated in 1993 and the Venezuelan Senate was eliminated in 1999.

In our workhorse models, we include the following controls. *Real per capita income* (logged) is included because wealthier countries have a greater demand for banking, credit, and public goods. We control for *economic growth* because higher growth rates may stimulate credit and asset booms. We include $\log(\text{population})$ because the scope of both credit markets and government regulation may be characterized by economies of scale. *Total resources income per capita* (logged) is included because foreign direct investment into the energy sector might depress the demand for domestic capital.³⁹ *Trade openness*, measured as exports plus imports as a percentage of GDP, from *Penn World Table 6.3*,⁴⁰ is included because it might bolster market-based mechanisms for capital allocation. *Old-age ratio*, from the World Bank Development Indicators, is the percentage of the population above sixty-five years of age; an older population may drive down both the savings rate and demand for credit. We lag all of these controls by one period to mitigate reverse causation.

EVIDENCE

PRELIMINARY ANALYSIS

Before performing our regression analysis, we assess some representative—and not-so-representative—cases. We first identify relevant financial outcomes, including changes in private credit, for several LATAM countries that democratized with popular constitutions or in the wake of subsequent constitutional reforms. We then examine the trajectories of the financial system for two of Latin America's biggest economies, Argentina and Brazil, in the aftermath of their democratizations. We also address the anomalous case of Chile, which experienced rapid financial development after democratization despite the fact that it inherited a constitution from the preceding autocratic period.

Consider the following cases of financial development in the wake of popular democratizations. In Argentina, which adopted a constitution after democratization, the ratio of private credit to GDP increased by 15 percent (from 13.44 percentage points to 15.51 percentage points) after the transition (1983–2006) compared to the autocratic period (1976–82). In Honduras, the ratio increased by 13 percent (from 27.5 percentage points to 31 percentage points) after the transition (1982–2006) compared to the autocratic period (1972–81). In Brazil, private

³⁹ All these variables are from Haber and Menaldo 2011.

⁴⁰ Heston, Summers, and Aten 2009.

credit increased by 94 percent (from 16.23 percentage points to 31.51 percentage points) after the government annulled a constitution inherited from the autocracy in 1988. In Colombia, private credit increased by 21 percent (from 22 percentage points to 26.65 percentage points) after it annulled its autocratic constitution in 1991. Moreover, a series of financial reforms in Argentina and Brazil and their associated outcomes are consistent with expectations.

After pegging its exchange rate to the US dollar in 1991, Argentina undertook many reforms intended to liberalize its banking sector, including privatizing several banks and allowing foreign ownership, which spurred increased competition by lenders, concomitantly broadening access to credit. This action led to an increase in banking system assets from 20 percent of GDP in 1991 to 40 percent in 1999.⁴¹ The average annual growth in private credit between 1995 and 1999 was 6.1 percent.⁴²

These observations by no means minimize the damage that was done to Argentina's financial system in the wake of the currency and banking crisis of 2001—a shock precipitated by a bank run due to increasing concerns about the sustainability of the Argentine currency board. The damage included the imposition of capital controls, the insolvency of some banks, and the nationalization of others.⁴³ One can argue that a principal reason for this crisis was not financial liberalization per se, but rather not enough of it, because one of the main risks that eroded confidence in the dollar peg was the fact that several important provincial banks remained in state hands and engaged in politicized lending that weakened their balance sheets.⁴⁴ Indeed, had the Argentine government fully completed its privatization plan sooner, the crisis might have been avoided.⁴⁵

Brazil has a similar, if not more successful, story. Its financial liberalization began in the late 1980s, shortly after it annulled a constitution it had inherited from the previous authoritarian regime. Included within these reforms was the opening of competition in the banking sector to foreigners, which increased access to credit and reduced interest rates. The average annual growth in private credit between 1990 and 1994 was 5.8 percent.⁴⁶ Although in 1994 Brazil suffered a banking crisis similar to Argentina's (outlined above), financial liberalization continued

⁴¹ Cohen et al. 2004, 35.

⁴² Laeven and Valencia 2008.

⁴³ Laeven and Valencia 2008.

⁴⁴ Cohen et al. 2004, 35.

⁴⁵ Vo and Williams 2013, 51.

⁴⁶ Laeven and Valencia 2008.

apace after the government engaged in bank recapitalizations and liquidations.⁴⁷ Further reforms under Fernando Cardoso (1995–98) included the privatization of several state banks. The result was rapid financial development. Bank lending increased by 44 percent from 1994 through 1995 alone in the wake of a stabilization plan called the Real Plan.⁴⁸ Financial deregulation was then intensified during Cardoso's second term (1999–2002) and Luiz Inácio Lula de Silva's first term (2003–6). The size of the banking sector in terms of assets and clients has trebled in size since 2000.⁴⁹

What about Chile? Its recent history is an aberration from the perspective of our theory. Chile democratized in 1989 with a constitution that was a holdover from the previous autocratic regime, having been imposed by a military junta in 1980. Yet rather than observe financial repression and politicized finance benefitting a few oligarchs at the expense of the majority after democratization, financial liberalization and development ensued. The ratio of private credit to GDP increased by 67 percent (from 31.52 percentage points to 52.66 percentage points) post-transition (1990–2006) compared with the autocratic period (1973–89).

What explains this puzzle? The chief reason is the original impetus behind Augusto Pinochet's dictatorship, which wrested power from Salvador Allende in 1973 after a violent coup. The military's intervention was a direct and strong reaction against the communist policies that the Allende regime had adopted, ensuring that the pendulum would swing wide in the opposite direction. Besides the serial violation of property rights under Allende, in which entire sectors, including banking, were expropriated and nationalized, a wave of populist macroeconomic policies spurred stagflation and destroyed living standards, precipitating a severe economic and political crisis.⁵⁰

With support from the wealthy, the middle class, and the United States, Pinochet proceeded to stabilize and privatize the economy, in part by adopting policies that deregulated the economy and financial sector. To reverse the damage done by the economic distortions engendered by the Allende regime, Chile's new dictatorship eliminated interest-rate and credit-allocation controls, reduced reserve requirements, and privatized the banks.⁵¹ Despite a financial crisis induced

⁴⁷ Baer and Nazmi 2000.

⁴⁸ Vo and Williams 2013, 52.

⁴⁹ Roett 2011, 122.

⁵⁰ Larraín and Meller 1991.

⁵¹ Despite this move toward privatization, Chile's banks were auctioned off to the country's business elite, or *grupos económicos*, in a patently illiberal fashion: they were allowed to purchase the banks at low prices with loans from the banks themselves and with the collateral constituting bank shares. Barandiarán and Hernández 1999. We thank an anonymous reviewer for pointing this out.

in part by exchange-rate overvaluation and a too-rapid expansion of credit in 1981, financial liberalization was consolidated in the wake of recapitalizations and liquidations,⁵² creating a coalition of bankers who had a strong stake in perpetuating neoliberal policies.⁵³ The coalition's influence endured after democratization, in part because of the 1980 constitution. Moreover, several reforms adopted by Pinochet had a lingering impact after the transition, including stronger property-rights protections and the rule of law;⁵⁴ the privatization of the pension system, which created incentives to reinforce a vibrant financial sector; and enhanced credit reporting.⁵⁵

In the next section, we adduce strong evidence that shows that Chile is the exception that proves the rule. It is popular democracies, not elite-biased ones, which usually evince financial development.

ECONOMETRIC ANALYSIS

We now estimate a series of static fixed-effects models via ordinary least squares (OLS) with Driscoll-Kraay standard errors to test the relationship between regime changes and financial development. This technique addresses heteroskedasticity, serially correlated errors, and spatial correlation.⁵⁶ The models share this structure:

$$y_{it} = \alpha_i + \lambda_t + \beta X_{it-1} + (\varphi \times \alpha_i) \xi + u_{it}, \quad (1)$$

in which y_{it} is the estimated value of the outcome variable of interest for country i in year t ; α_i addresses time-invariant country fixed effects and λ_t addresses country-invariant year fixed effects both potentially correlated with X , a vector of k explanatory variables lagged by one year in most cases; β are estimated parameters; ξ are estimates of country-specific time trends produced by the interaction between φ , a linear time trend, and α_i ; and u_{it} , an error term.⁵⁷

⁵² Laeven and Valencia 2013.

⁵³ Díaz-Alejandro 1985.

⁵⁴ Haber 2009.

⁵⁵ The Pinochet regime eventually reprivatized Chile's banks following the damage wrought by the banking crisis of the early 1980s. Indeed, in the aftermath of the crisis, financial development had cratered, and the government was forced to reprivatize the banking system with real capital. This action catalyzed a rapid increase in private credit to GDP—which was not entirely surprising given the very low baseline levels—that preceded the reprivatization. This trend then continued after democratization. Barandiarán and Hernández 1999.

⁵⁶ This technique involved making a Newey-West adjustment to the error term, the lag length of which was determined via Arellano-Bond tests of serial correlation.

⁵⁷ Controls for country fixed effects, year fixed effects, country-specific time trends, and several time-varying controls allow us to expunge multiple sources of both time-invariant and time-varying omitted variables. On one hand, they exploit the data's within-country variation, thus ruling out

Across the models, x always includes the three main independent variables noted above: *regime type*, *democracy with autocratic constitution*, and *democracy amends autocratic constitution*. Each enters the regression equations in levels. This means that the raw coefficient on *democracy with autocratic constitution* is the difference in financial outcomes between countries that transitioned to democracy with an autocratic constitution and those that democratized with their own constitutions. Across the regression tables, we also report changes in these outcomes induced by different types of transition.

The calculation of these changes is made possible by the fact that simple, linear transformations of the estimated beta coefficients allow us to produce theoretically meaningful estimates. Adding the coefficient on *regime type* and the coefficient on *democracy amends autocratic constitution* yields an estimate of the change in financial outcomes produced by a popular democratic transition, one in which no autocratic constitution is inherited. Meanwhile, adding the coefficient on *regime type*, the coefficient on *democracy amends autocratic constitution*, and the coefficient on *democracy with autocratic constitution* yields an estimate of the change in outcomes produced by an elite-biased democracy that inherits an autocratic constitution.⁵⁸ For ease of interpretation, we omit the raw coefficients for *regime type* and *democracy amends autocratic constitution* and instead report these transformations.⁵⁹

Table 2 presents the results of these models. All regressions control for country fixed effects, year fixed effects, and country-specific time trends. The even-numbered models include all the time-varying control variables outlined above. The odd-numbered models are restricted to three main independent variables. Although we center our discussion of the results on the unrestricted specifications (even-numbered models), the results across the models are consistent with theoretical expectations.

Elite-biased democracies are less financially developed than democracies with their own constitutions. Specifically, democracies that operate under autocratic constitutions have smaller banking systems as measured by deposits, allocate a smaller amount of private credit, have smaller stock markets, and are less likely to have liquid financial

country-specific heterogeneity that is constant over time. Said heterogeneity includes religion, culture, legal origin, factor endowments, and history. On the other hand, across all our models we include a series of time-varying factors that influence both the demand for, and supply of, finance. Yet because the results may nonetheless be confounded by the omission of other, unobserved, and time-varying variables, we also include country-specific time trends.

⁵⁸ The baseline in both cases is the autocratic regime category.

⁵⁹ Standard errors for each of these calculations are estimated via the Delta Method.

TABLE 2
 PANEL REGRESSIONS ON LATIN AMERICAN FINANCIAL SYSTEM, 1965–2006^a

<i>Dependent Variable</i>	<i>Model 1</i>		<i>Model 2</i>		<i>Model 3</i>		<i>Model 4</i>		<i>Model 5</i>		<i>Model 6</i>		<i>Model 7</i>		<i>Model 8</i>		<i>Model 10</i>		
	<i>Liquidity</i>	<i>Liquidity</i>	<i>Total Deposits</i>	<i>Total Deposits</i>	<i>Private Credit</i>	<i>Private Credit</i>	<i>Market Capitalization</i>	<i>Market Capitalization</i>	<i>Stock Market Capitalization</i>	<i>Stock Market Capitalization</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	<i>Financial Reforms</i>	
Difference between elite-biased and popular democracy	-4.082*** (1.265)	-3.070** (1.257)	-3.667** (1.478)	-2.55 (1.530)	-7.612*** (2.663)	-7.884*** (2.538)	-17.26* (8.701)	-13.871** (6.239)	-0.441 (0.272)	-0.842** (0.341)									
Δ from autocracy to popular democracy	6.856*** (1.475)	6.528*** (1.338)	5.944*** (1.716)	5.255*** (1.656)	6.128 (2.861)**	6.944 (2.457)***	16.151** (7.631)	14.556** (5.922)	0.112 (0.371)	0.501 (0.316)									
Δ from autocracy to elite-biased democracy	2.773*** (0.736)	3.458*** (0.723)	2.278*** (0.756)	2.706*** (0.726)	-1.484 (1.614)	-0.940 (1.560)	-1.108 (5.314)	0.687 (4.542)	-0.329 (0.296)	-0.341 (0.271)									
Log(per capita income) _{<i>t-1</i>}		-6.540* (3.750)		-3.876 (2.953)		0.325 (6.203)		14.1 (18.03)		0.76 (0.498)									
Real growth rate _{<i>t-1</i>}		6.406 (5.206)		2.006 (4.000)		1.051 (5.136)		-33.05* (17.68)		2.822*** (1.199)									
Log(natural resources per capita) _{<i>t-1</i>}		-1.250*** (0.427)		-1.473*** (0.383)		-2.498** (0.492)		4.194 (4.365)		-0.568*** (0.182)									
Log(population) _{<i>t-1</i>}		91.27*** (17.40)		96.30** (15.11)		29.58 (24.49)		1,276** (218.9)		16.51*** (2.061)									
Old-age ratio _{<i>t-1</i>}		4.442*** (0.991)		6.155*** (0.843)		3.172 (2.286)		34.36** (15.86)		0.141 (0.189)									
Trade openness _{<i>t-1</i>}		0.033* (0.016)		0.023 (0.013)		0.040 (0.028)		0.057 (0.178)		0.018** (0.009)									
Country fixed effects	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes
Country-specific time trends	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes
Observations	814	814	844	844	844	844	250	250	250	250	250	250	250	250	250	250	250	250	250
Number of countries	22	22	22	22	22	22	19	19	19	19	19	19	19	19	19	19	19	19	19

* p<0.1** p<0.05, *** p<0.01

^aIntercept estimated but not reported. Driscoll-Kraay standard errors estimated with a Newey-West, one-lag adjustment. Country fixed effects netted out via within transformation.

systems.⁶⁰ Democracies with autocratic constitutions also have less financial reform oriented toward reducing barriers to entry in the financial system, privatizing nationalized banks, and cultivating securities markets. Except for *total deposits* (model 4), for which the p-value is .11, the results are statistically significant at the .05 level or better.

Moreover, the negative effect of autocratic constitutional legacies on financial development is substantial. *Ceteris paribus*, liquidity (as a percentage of GDP) is 3.1 percentage points smaller for elite-biased democracies than for popular ones. The effect on total bank deposits is similar. Private credit is nearly 7 percentage points smaller for elite-biased democracies. Stock markets are, on average, 17 percentage points smaller for elite-biased democracies. Finally, on a nine-point scale, they are almost one point less financially liberalized on the financial reforms index.

Similarly, the transition to popular democracy from autocracy is a boon for financial development. Transitions in which new democracies adopt their own constitution unleash more liquid financial systems than autocracies and have larger banking systems, a greater share of private credit, and larger stock markets. Except for the results on the size of the stock market, for which the p-value is .02 (model 8), and financial reforms, for which it is .13 (model 10), the results are statistically significant at greater than the .01 level.⁶¹

The results are also substantively significant. While stock markets grow 16 percentage points (as a percentage of GDP) on average after a transition to popular democracy, private credit increases by 7 percentage points. Liquidity increases by an almost identical magnitude.

The transition to elite-biased democracy from autocracy does not make much difference to financial development. Although these transitions stimulate greater liquidity in the financial system and attract a larger deposit base at conventional levels of statistical significance, they do not encourage the allocation of more credit (in model 6 this parameter is negative but not significant) or grow the stock market (in model 8 this parameter is positive but not significant). Nor do these transitions produce financial liberalization (in model 10 this parameter is negative but not significant).

⁶⁰ Popular democracies also have much larger private bond markets; but because there is only data coverage on seven countries for this variable, we omit these results.

⁶¹ The reason why it is difficult to estimate reliable point estimates when the dependent variable is *financial reforms* is because a great amount of financial liberalization in LATAM occurred in the 1990s in the wake of the international financial crisis associated with Mexico's 1982 sovereign debt default. This temporal clustering introduces a high degree of multicollinearity. If we remove the year fixed effects, then the results on *financial reforms* improve beyond the threshold of conventional statistical significance.

ROBUSTNESS TESTS

We took some additional steps to ensure that our main results are robust. First, to ensure that these findings are not driven by a particular case, we ran a series of panel jackknife regressions that serially drop each of our twenty-two countries across each of our dependent variables (*liquidity*, *total deposits*, *private credit*, *stock market capitalization*, and *financial reforms*). The results are robust to this procedure; none of the findings are materially altered in any substantive or statistical way after running these regressions.⁶²

Second, to ensure that the results are not sensitive to the way in which we coded cases that might be reasonably coded differently, we reran the regressions after recoding the Argentine and Colombian constitutions, respectively. In the case of Argentina, we recoded its 1957, 1962, and 1972 charters as popular constitutions rather than as elite-biased. In each of these democratic interludes the new democrats actually restored the 1853 constitution, rather than strictly inherit a constitution from the previous autocratic regime. Similarly, in the case of Colombia, we recoded the constitution as a popular one between 1958 and 1991, given that the National Front arrangement codified that year was juxtaposed upon a previous, democratic charter. The results of these experiments did not make a material difference to the basic findings. For example, after recoding Argentina from an elite-biased to a popular democracy as outlined above, the point estimate for the difference between elite-biased democracy and popular democracy in the regression in which private credit is the dependent variable actually strengthens to -8.4 , versus -7.6 , with the same very high statistical significance (p -value $< .01$).⁶³

TESTING THE MECHANISMS

We now empirically test whether the effect of transitions to popular democracy on financial development is actually running through the mechanisms outlined by our theory, rather than an alternative one. We

⁶² These panel jackknife regressions are contained in Menaldo and Yoo 2015.

⁶³ To address any remaining endogeneity bias, we also estimated a series of dynamic regressions using the System Generalized Method of Moments (GMM). This involved performing several operations to equation (1): first-differencing the variables to expunge the country fixed effects; instrumenting the lagged dependent variable with available lags in levels; instrumenting the regime variables we had used hitherto to calculate the effects of interest with available lags in levels; and adding the original, undifferenced equation to the system to instrument these variables with lags of their first differences. We used the two-step estimator to ensure that the results were robust to autocorrelation and heteroskedasticity; year fixed effects addressed spatial dependence. The results are highly significant in both a substantive and statistical sense. Moreover, a Sargan test of the overidentifying restrictions returns a chi-square of 13.81 (p -value = 0.61) and an Arellano-Bond test of AR(2) returns a z-score of -0.68 (p -value = 0.50), satisfying the GMM requirement that there be no autocorrelation in levels.

take a multipronged approach. The first is to rule out alternative explanations. This is accomplished by the regressions represented in Table 3. The second is to see if an ancillary empirical implication generated by our theory is borne out empirically, and Table 4 reports the results of that experiment. The last action is to serially include each of the constitutional features outlined in Table 1 on the right-hand side of the regressions to see if they help explain the variation in financial development while attenuating the substantive and statistical significance of the overall elite-biased measure. Table 5 reports the results when *private credit* is the dependent variable.

CONTROLLING FOR ALTERNATIVE LEGACIES

The regressions in Table 3 satisfy two objectives. The even-numbered models test the hypothesis that the correlations between regimes and financial development uncovered in Table 2 are actually driven by alternative political legacies, not by the constitutional design of the post-democratization regime. The odd-numbered models test the hypothesis that the correlations are instead explained by macroeconomic legacies that might be correlated with different constitutional arrangements.

To measure political legacies, we follow Joseph Wright and Abel Escribà-Folch, and include a bevy of dummy variables that identify whether the autocratic regime in place before democratization was a single-party regime, military regime, or personalist regime.⁶⁴ The baseline category here is transitional regimes in which rulers were in office less than one year.⁶⁵ The logic of this strategy is that it might not be the constitution that the succeeding democracy operates under that matters after transition but, instead, the de facto legacies of power left over by either hegemonic parties or military juntas, for example. While single-party legacies appear to be good for the financial system after democratization, the main results in the even-numbered models in Table 3 are robust, both statistically and substantively, to the inclusion of these variables.

What if the actual political parties that thrived under autocracy are carried over to the democratic regime? Might it be this legacy, and not the constitution that is left behind, that enables key players from the previous regime to perpetuate financial repression after democratization, perhaps by allowing them to win elections under democracy? This

⁶⁴ Wright and Escribà-Folch 2012.

⁶⁵ Included are variables for whether the leader evidences a single party, military, personalist, or “oligarchic” component; the results are also robust to using pure regime types. These variables are from Albertus and Menaldo 2014b.

TABLE 3

PANEL REGRESSIONS: EXCLUSION OF POLITICAL AND MACROECONOMIC LEGACIES AS ALTERNATIVE EXPLANATIONS, 1965–2006^a

<i>Dependent Variable</i>	<i>Model 1</i>		<i>Model 2</i>		<i>Model 3</i>		<i>Model 4</i>		<i>Model 5</i>		<i>Model 6</i>		<i>Model 7</i>		<i>Model 8</i>	
	<i>Liquidity</i>	<i>Liquidity</i>	<i>Total De-</i>	<i>Total De-</i>	<i>Total De-</i>	<i>Private</i>	<i>Private</i>	<i>Private</i>	<i>Private</i>	<i>Private</i>	<i>Private</i>	<i>Private</i>	<i>Market</i>	<i>Market</i>	<i>Market</i>	<i>Market</i>
Difference between elite-biased and popular democracy	-3.678*** (1.268)	-3.977*** (1.440)	-3.216* (1.629)	-3.707** (1.475)	-7.887*** (1.772)	-10.38*** (1.800)	-9.25 (7.114)	-18.10* (9.762)	-0.781*** (0.266)	-0.477 (0.294)						
Δ from autocracy to popular democracy	6.038*** (1.903)	6.977*** (1.298)	4.848** (2.081)	5.483*** (1.649)	6.533** (2.8)	10.567*** (2.147)	4.706 (9.955)	14.691* (8.585)	0.245 (0.268)	0.649** (0.269)						
Δ from autocracy to elite-biased democracy	2.36 (1.594)	3*** (0.903)	1.632 (1.506)	1.775** (0.847)	-1.355 (2.283)	0.184 (1.486)	-4.544 (4.791)	-3.407 (5.933)	-0.536** (0.198)	0.172 (0.224)						
Personalist dictatorship legacy	2.092 (1.643)	6.977*** (1.298)	3.373** (1.384)	3.373** (1.384)	-3.725*** (1.060)	15.05* (7.588)	15.05* (7.588)	15.05* (7.588)	-1.270** (0.519)	0.245 (0.268)						
Military dictatorship legacy	-0.93 (1.412)	6.977*** (1.298)	-0.841 (1.366)	-0.334 (2.377)	-0.334 (2.377)	9.758 (11.45)	9.758 (11.45)	9.758 (11.45)	0.481** (0.218)	0.172 (0.224)						
Single-party dictatorship legacy	8.853*** (2.406)	7.107*** (1.878)	7.107*** (1.878)	7.107*** (1.878)	7.795*** (2.535)	-10.61 (7.525)	-10.61 (7.525)	-10.61 (7.525)	0.106 (0.383)	0.106 (0.383)						
Overvalued exchange-rate legacy	-0.853 (0.556)	-0.853 (0.556)	-0.853 (0.556)	-0.588 (0.511)	-0.853 (0.604)	-0.853 (0.604)	-0.853 (0.604)	-0.853 (0.604)	1.463 (1.198)	-0.209* (0.112)						
Full set of controls from table 2	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes						
Country fixed effects	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes						
Year fixed effects	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes						
Country-specific time trends	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes						
Observations	814	594	844	620	844	620	250	182	561	433						
Number of countries	22	18	22	18	22	18	19	14	17	14						

* p<0.1, ** p<0.05, *** p<0.01

^aIntercept estimated but not reported. Driscoll-Kraay standard errors estimated with a Newey-West, one-lag adjustment. Country fixed effects netted out via within transformation. Full set of controls from Table 2 estimated but not reported; these are $\log(\text{per capita income})$, real growth rate , $\log(\text{natural resources per capita})$, $\log(\text{population})$, old-age ratio , and trade openness , all lagged one year.

is not the case. The results are also robust to including the number of political parties observed at the end of the previous autocratic episode (not reported).⁶⁶

The odd-numbered models in Table 3 include a measure of macroeconomic legacies on the eve of democratization, specifically, the degree of exchange-rate overvaluation the year prior to democratization.⁶⁷ The logic of including this measure is that countries that had overvalued exchange rates under authoritarianism might eventually need to devalue their currencies at some point after transition. Their pegs may prove unsustainable and eventually run their course—especially if democratization is associated with turmoil, uncertainty, and capital flight. Because the downward adjustment of overvalued exchange rates may call upon dismantling capital controls and associated measures of financial repression, doing so would be associated positively with financial liberalization.

The results in the odd-numbered models in Table 3 are robust, both statistically and substantively, to this experiment. We note that the results are also robust to controlling for the rate of inflation on the eve of democratization (not reported). We thus conclude that the results in Table 2 are not being driven by legacies of macroeconomic instability.

INEQUALITY, REGIME TYPE, AND FINANCIAL SYSTEMS

As another test of the theoretical mechanisms outlined above, we now check to see whether the effect of the distribution of income on financial outcomes is conditioned by regime type. The logic is as follows. When income inequality is high, asset inequality tends to be high as well.⁶⁸ And even after controlling for absolute levels of wealth, greater income and asset inequality usually mean that there are fewer opportunities for the poor majority to generate and reinvest the profits required to finance important investments. Thus, we should expect to find that heightened inequality under popular democracy leads to a greater range of financial outcomes preferred by the poor majority, most particularly abundant and cheap credit. But increased inequality under elite-biased democracy should make no difference to financial development.

In Table 4 we test this hypothesis through a series of models that include the interaction of *income inequality* and our different regime-

⁶⁶ This variable is from Albertus and Menaldo 2014b.

⁶⁷ The degree of exchange-rate overvaluation is an index of the overvaluation of the real exchange rate from the Global Development Network Growth Database, at <http://www.nyudri.org/resources/global-development-network-growth-database/>, accessed May 25, 2015. The results are robust to calculating several moving averages instead.

⁶⁸ Easterly 2007.

TABLE 4
 PANEL REGRESSIONS: EXCLUSION OF INCOME INEQUALITY AS AN ALTERNATIVE
 EXPLANATION, 1965–2006^a

<i>Dependent Variable</i>	<i>Model 4</i>				
	<i>Model 1</i> <i>Liquidity</i>	<i>Model 2</i> <i>Total</i> <i>Deposits</i>	<i>Model 3</i> <i>Private</i> <i>Credit</i>	<i>Stock Market</i> <i>Capitali-</i> <i>zation</i>	<i>Model 5</i> <i>Financial</i> <i>Reforms</i>
Income inequality under popular democracy	1.277** (0.490)	1.405*** (0.438)	1.545*** (0.504)	8.716*** (3.177)	0.118 (0.082)
Income inequality under elite-biased democracy	-0.109 (0.397)	0.117 (0.298)	0.252 (0.381)	4.217 (4.286)	0.259*** (0.062)
Income inequality under autocracy	0.680*** (0.141)	0.825*** (0.103)	1.337*** (0.169)	3.527 (3.175)	0.179*** (0.0346)
Personalist dictatorship legacy	5.978*** (1.327)	6.772*** (1.223)	10.05*** (1.562)	94.07 (123.9)	-1.563*** (0.324)
Military dictatorship legacy	3.679** (1.337)	5.360*** (1.396)	-0.839 (1.737)	-123.1 (181.7)	1.016*** (0.287)
Single-party dictatorship legacy	-9.390*** (1.814)	-9.451*** (1.670)	-7.660*** (2.130)	-67.1 (49.57)	-0.339 (0.315)
Overvalued exchange- rate legacy	-2.725*** (0.772)	-1.680** (0.681)	-1.626** (0.747)	-19.68 (27.52)	0.539*** (0.126)
Full set of controls from Table 2	yes	yes	yes	yes	yes
Country fixed effects	yes	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes	yes
Observations	567	567	567	182	433
Number of countries	17	17	17	14	14

* p<0.1, ** p<0.05, *** p<0.01

^aIntercept estimated but not reported. Driscoll-Kraay standard errors estimated with a Newey-West, one-lag adjustment. Country fixed effects netted out via within transformation. Full set of controls from Table 2 estimated but not reported: $\log(\text{per capita income})$, real growth rate , $\log(\text{natural resources per capita})$, $\log(\text{population})$, old-age ratio , and trade openness , all lagged one year.

type categories: popular democracy and elite-biased democracy.⁶⁹ We measure *income inequality* as the Gini coefficient, which ranges from 0 to 100; larger values denote greater inequality. This variable is from the Standardized World Income Inequality Database, which standardizes differences in Gini coefficients across countries vis-à-vis the scope of

⁶⁹ These models include all the control variables, including the alternative political legacies, for example, whether the previous regime was a single-party dictatorship, and macroeconomic legacies. We drop the country-specific time trends because they are nearly perfectly correlated with the variation over time in the Gini coefficients.

coverage, income definition, and reference unit.⁷⁰ Because the beta coefficients on the dummy variables used to operationalize regime types are estimates of the effect of the distribution of income when the Gini coefficient equals zero (and to conserve space), we omit them from the regression tables. We instead report and focus only on the slopes of inequality for each regime type: popular democracy, elite-biased democracy, and autocracy (the latter can be gleaned directly from the beta coefficient of *income inequality*).⁷¹

The results yielded by this experiment corroborate our theoretical mechanism. Greater degrees of income inequality do consistently yield more financial development, but only in popular democracies. As the distribution of income becomes more skewed in these regimes, it increases liquidity, bank deposits, private credit, and the size of the stock market, effects that are both substantively and statistically significant (the coefficient on *financial reforms* is positive but not statistically significant at conventional levels); for example, increasing the degree of income inequality by 1 point in popular democracies yields an increase of 8.7 percentage points in the size of the stock market.

THE EFFECT OF SPECIFIC CONSTITUTIONAL FEATURES

As a final test of the theoretical mechanisms outlined above, we estimate a set of additional regressions in which we add to the right-hand side of the regression equation the distinct constitutional features found in LATAM's elite-biased democracies. Specifically, the features that are introduced include those identified in Table 1: bicameralism, indirect elections, banning of left-wing parties, and appointment of senators. We inserted each of the constitutional features independently (one at a time) into each of the regressions, while also including the original set of control variables, country fixed effects, year fixed effects, and country-specific time trends (thus mirroring the regression in Table 2, model 3).

Table 5 shows the results when *private credit* is the dependent variable. In model 1, we add *inherited bicameralism*. In model 2, we add *banning of left-wing parties*. In model 3, we add *indirect presidential elections*.

⁷⁰ Solt 2014.

⁷¹ To estimate the effect of inequality across regime types, we perform the following calculations. To estimate its effect in a popular democracy, we add the coefficient on *income inequality*, the coefficient on the interaction between *income inequality* and *regime type*, and the coefficient on *income inequality* and *democracy amends autocratic constitution*. To estimate the effect of *income inequality* in an elite-biased democracy we add the coefficient on *income inequality*, the coefficient on its interaction with *democracy with autocratic constitution*, and the coefficient on the uninteracted term. Standard errors for each sum are estimated via the Delta Method.

TABLE 5
 PANEL REGRESSIONS: INTRODUCTION OF ELITE-BIASED
 CONSTITUTIONAL FEATURES, 1965–2006^A

<i>Dependent Variable</i>	<i>Model 1 Private Credit</i>	<i>Model 2 Private Credit</i>	<i>Model 3 Private Credit</i>	<i>Model 4 Private Credit</i>	<i>Model 5 Private Credit</i>
Difference between elite-biased and popular democracy	-4.172 (2.985)	-6.933*** (2.304)	-7.820*** (2.463)	-6.052* (2.961)	-2.269 (3.425)
Inherited bicameralism	-4.917 (3.366)				-3.838 (3.543)
Banning of left-wing parties		-2.544* (1.416)			-3.361** 1.455
Indirect presidential elections			-0.415 (3.151)		-0.325 (1.877)
Appointed senators				-5.358* (2.718)	-4.124 (3.087)
Mechanisms combined					-11.648*** (0.018)
Full set of controls from Table 2	yes	yes	yes	yes	yes
Country fixed effects	yes	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes	yes
Country-specific time trends	yes	yes	yes	yes	yes
Observations	844	844	844	844	844
Number of countries	22	22	22	22	22

* p<0.1, ** p<0.05, *** p<0.01

^AIntercept estimated but not reported. Driscoll-Kraay standard errors estimated with Newey-West adjustment. Country fixed effects netted out via within transformation. Full set of controls from Table 2 are estimated but not reported: $\log(\text{per capita income})$, real growth rate , $\log(\text{natural resources per capita})$, $\log(\text{population})$, old-age ratio , and trade openness , all lagged one year.

In model 4, we add *appointed senators*. Finally, in model 5 we add all these constitutional features simultaneously and calculate the cumulative impact they make.⁷²

The results of this experiment are consistent with our theory. Although these features reduce the amount of private credit in a democracy, introducing them attenuates the substantive and statistical significance of the elite-bias variable. Each time we add a constitutional feature (across models 1 to 4), that particular feature has the expected sign (it

⁷² This result is calculated by adding their coefficients together and using the Delta Method to arrive at the standard error on this point estimate.

is negative) and is statistically significant (although never under the 5 percent level) or just shy of being statistically significant. Moreover, as expected, the point estimate on the difference between popular and elite-biased democracy is always reduced (see Table 2, model 3 for the benchmark comparison) and loses statistical significance. In model 5, in which each variable is entered simultaneously, the cumulative effect of all variables is a reduction of 9.27 percentage points in private credit (p-value = .02) compared to the -2.98 coefficient on the difference made by elite-biased democracy, which is now no longer statistically significant (p-value = 0.51).⁷³

CONCLUSION

Many researchers argue that democracy induces financial development via the efficient, market-based allocation of capital. Yet the empirical evidence that supports this claim has been, at best, mixed. To make sense of this fact, we introduce a theoretical framework that ties a democracy's constitutional origins to the ensuing trajectory of its financial system. Democracies with legacies that incentivize policymakers to appeal to the median voter, which we proxy for with the adoption of their own constitution after transition, adopt financial reforms that benefit the majority by increasing the supply of credit and reducing its price. Conversely, elite-biased democracies in which the economic elite were able to impose, before the transition, a constitution that overrepresents their interests, erect barriers to entry in the financial sector and ration capital—maximizing rents but retarding financial and, thus, economic development.

We corroborate these predictions empirically in LATAM between 1965 and 2006. This region is an ideal laboratory to test our theory because we are able to exploit the sizable variation over time there in both financial development and political institutions, in particular, the changes from autocracy to different types of democracy. As expected, we find that democratic countries with constitutions imposed on them by outgoing autocrats are less likely to liberalize their financial system. In turn, they discourage deposit banking, exhibit less-liquid financial transactions, have a smaller supply of credit, and have smaller stock markets. In contrast, democracies that adopt their own constitutions

⁷³ It is not a surprise that some of the constitutional features are not statistically significant at conventional levels across models 1 to 4, given how highly correlated they are with the elite-biased variable. The correlation for *bicameralism* and the latter is 0.67 (p-value < .01); the correlation for *banning of left-wing parties* is 0.60 (p-value < .01); the correlation for *indirect presidential elections* is 0.18 (p-value < .01); and for *appointed senators* is 0.35 (p-value < .01).

develop a larger and more sophisticated financial system. Therefore, while we have generally ratified the thesis that institutions and, most particularly, regime types, matter for financial development, we have also shown that not all democracies are created equal.

Our paper raises several questions for future research, including whether popular democracies are more likely to suffer from banking crises than elite-biased ones. Other research could include whether our main predictions hold outside of Latin America.

Do democracies that have their own constitutions tend to have a higher likelihood of experiencing a financial crisis than democracies with constitutions inherited from their autocratic predecessors? While we conducted some preliminary analyses to evaluate this question, the findings are far from conclusive.⁷⁴ The results of these experiments suggest that, somewhat surprisingly, popular democracies with their own constitutions are not more likely than elite-biased democracies to experience a banking crisis, despite the fact that they are more likely to usher in credit booms. Moreover, democracies of both types are no more likely to experience banking crises than autocracies.⁷⁵

Why are popular democracies seemingly not more likely to experience banking crises in Latin America? One possibility is that these countries' tax systems are highly regressive and any bailouts and similar government subsidies applied in the wake of a banking crisis would be financed by the median voter. This might diminish the majority's support for reducing lending standards too much or for pushing banks to make loans that are too risky. It might also incentivize the median voter to support prudential regulation.⁷⁶

While this intuition seems to be corroborated by the fact that popular democracies have more reserves than elite-biased democracies, which is suggestive of the fact that the median voter may prefer prudential regulation of the financial system to avoid incurring the costs of banking crises, we leave it to future research to test this conjecture more

⁷⁴ To capture this concept, we used the measure of systematic banking crises conceptualized and coded by Laeven and Valencia 2013.

⁷⁵ We estimated a series of conditional logit regressions (clogits) via maximum likelihood to control for country-specific, time-invariant heterogeneity, as well as pooled regressions using a population averaged approach suited for panel data with an adjustment for serial correlation. Unrestricted specifications included the controls and year fixed effects.

⁷⁶ Consider that the ratio of indirect taxes (sales and excise taxes) to direct taxes (income, property, and capital gains) in Latin America is the highest in the world according to data from the IMF's Government Finance Statistics Database (1972 to 2006), at <http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&ce=170809>, accessed May 25, 2015. While this ratio averages 0.60 for the twenty-one high-income Organization for Economic Cooperation and Development (OECD) countries and 0.69 for non-OECD countries outside of Latin America, it averages 0.74 for the twenty-two Latin American countries. The average for all non-Latin American countries is 0.66 ($n = 127$).

systematically.⁷⁷ Such work would require looking at the relationship between different types of democracies and banking crises beyond Latin America. It might very well be the case that if median voters can externalize the costs of bank bailouts and associated subsidies, because they find themselves in a country with a progressive tax structure, they would very well push for policies that stoke credit booms that ultimately prove unsustainable; conceivably, this incentive would be strengthened if the voters could also secure debt relief in the aftermath of a banking crash.

Along these lines, another question that suggests itself is whether our main results travel beyond Latin America. Let us consider a few representative cases. Indonesia transitioned to democracy in 1999 under the auspices of a constitution inherited from the previous autocratic regime. Portugal transitioned to democracy in 1976 and then adopted a popular constitution. Spain transitioned to democracy in 1977, and although it did so under the auspices of an autocratic constitution, it annulled that charter a year later. Greece transitioned to democracy in 1974 and then adopted a popular constitution. Finally, there is South Africa. Its 1993 charter outlined a transitional power-sharing agreement from 1994 to 1999 in which the African National Congress agreed that the National Party, the ruling party under white rule, would form part of the government during this period. While cabinets were obliged to arrive at consensus decisions, minority groups were awarded a veto in local governments over policies that affected them. Moreover, a sunset clause protected military, police, and civil service members from being ousted after apartheid ended. Basically, this federal structure created a “hostage” game between white-run provinces, including the Western Cape, and the central government elected by the black majority, allowing the elite to block policies that countered their interests.⁷⁸

A cursory evaluation of the evidence bears out our predictions. As expected, in Indonesia, the ratio of private credit to GDP decreased by 33 percent (from 32.19 percentage points to 21.57 percentage points) after democratization (1999–2006) compared to the autocratic period (1960–99); in Portugal, it increased by 47 percent (from 58.05 percentage points to 85.24 percentage points) after its transition (1976–2006) compared to the autocratic period (1960–75). In Spain, private credit increased by 8 percent (from 76.70 percentage points to 82.64

⁷⁷ We measured reserves as regulatory capital to risk-weighted assets (available from the Archival Federal Reserve Economic Data Set at <http://alfred.stlouisfed.org/>, accessed May 25, 2015). Because this data runs only from 1998 to 2006, we ran pooled OLS models with year fixed effects and the set of control variables.

⁷⁸ See Inman and Rubinfeld 2008.

percentage points) after it annulled a constitution inherited from autocracy in 1978; in Greece, private credit increased by 136 percent (from 16.28 percentage points to 38.42 percentage points) after democratization. While these patterns are highly suggestive and imply that our theory might travel beyond Latin America, we leave it to future research to find out if this is indeed the case.⁷⁹

SUPPLEMENTARY MATERIAL

Supplementary material for this article can be found at <http://dx.doi.org/10.1017/S0043887115000192>.

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⁷⁹ Testing our theory on former communist regimes might be a good place to start, considering that while a few of them, such as Kyrgyzstan, inherited constitutions from their autocratic predecessors, others adopted their own after democratization.

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