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Finance and inequality: Channels and evidence ☆

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We provide a framework to interpret the recent literature on financial development and inequality. In many developing countries, access to funding and financial services by firms and households is still very skewed. Recent evidence suggests that poor access does not only reflect economic constraints but also barriers erected by insiders. Inequality affects the distribution of political influence, so financial regulation often is easily captured by established interests in unequal countries. Captured reforms deepen rather than broaden access, as small elites obtain most of the benefits while risks are socialized. Financial liberalization motivated to increase access may in practice increase fragility and inequality, and lead to political backlash against reforms. Thus financial reforms may succeed only if matched by a buildup in oversight institutions. *Journal of Comparative Economics* **35** (4) (2007) 748–773. IMF, USA; University of Amsterdam, The Netherlands; CEPR, UK.

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☆ The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and do not necessarily represent the views of the World Bank or the IMF.

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0. Introduction

This paper provides a conceptual review of the recent literature on financial development with a focus on financial access, and their links with inequality. The literature on financial development has largely dealt with how the size of the financial sector affects growth (Levine, 2005), and has only recently paid attention to the distribution of access to finance. Recent evidence has shown that financial development can help reduce inequality and poverty and that access to financial services is critical for individuals' productivity and welfare in developing countries. Banerjee and Duflo (2005), for example, review evidence of tight financial constraints for poor individuals as well as high marginal returns at a low level of capital investment.

Lack of financial access has long been recognized as a leading cause of persisting inequality. This review will argue that we need to recognize the reverse effect as well. Inequality affects financial development, and in particular the distribution of access, because unequal access to resources affects de facto political power (Acemoglu et al., 2005). Especially in a weak institutional framework, where de facto political influence dominates de jure political representation, inequality makes it easy for established interests to influence access to finance by direct control or regulatory capture of the financial system (Rajan and Zingales, 2003b; Perotti and Volpin, 2007).

The paper reviews recent evidence suggesting that unequal access to political influence produces unequal access to finance and ultimately unequal opportunities, which can reinforce any initial economic inequality. It does not review the vast literature on the determinants and impact of inequality. Economic inequality has been found in general to impede growth (for surveys see Aghion et al., 1999 and World Bank, 2005a; see also Banerjee and Duflo, 2003), although inequality may well increase in the short and medium term in periods of sustained economic growth (Forbes, 2000). Among the leading candidates to explain inequality are fractionalization (ethnic, linguistic or religious), human capital development, and political, economic and legal institutions (e.g., Acemoglu et al., 2005; Alesina et al., 2003; Glaeser et al., 2004; Engermann and Sokoloff, 2002).

Our approach draws from this literature that both economic inequality and (financial) underdevelopment are jointly determined by institutional factors which cause unequal access to political and contractual rights. Recent evidence points out that political accountability is a precondition for reliable enforcement and economic growth (Acemoglu and Robinson, 2005). Skewed political participation allows established interests to protect their rents by limiting financial access, and thus suppressing competition and entry. Perotti and Volpin (2007) present evidence that access to finance is better in more equal countries and in countries with greater political accountability, also after controlling for legal origin and economic development.

While evidence shows that financial reforms can support growth, political elites will resist changes which would lead to a decrease in their influence or rents (Acemoglu et al., 2005). We review here evidence that captured reforms in developing countries produce concentrated benefits while risks become socialized. Case evidence shows that financial crises arise from perverse incentives and have strong redistributive consequences. This undermines support for liberalization, and the political backlash will set reforms back and hurt sustained growth which could reduce inequality. In conclusion, inequality can become self sustained as it affects financial regulation and the evolution of the financial system.

So is there still a role for financial reforms? We conclude that in countries with high inequality, a reform path may need to be gradual, aimed explicitly at reducing inequality of access, maintaining support for competition paired up with a build up of oversight institutions. Only then can reforms be expected to improve access, prevent opportunism, and lead to sustained and broad financial development.

The structure of the paper is as follows. Section 1 reviews the evidence on finance and development, the links between finance and inequality, the degree of equality in access, and the impact of unequal access. Section 2 considers the causes of inequality in financial access, differentiating natural barriers, and forms of political influence through indirect and direct control leading to unequal access. Section 3 reviews the experience with financial reform in the context of inequality, distinguishing channels of timing, and allocation of benefits and risks. Section 4 concludes with some lessons on financial reform.

1. Finance and inequality[1]

We review here evidence on three issues: whether deeper financial markets lead to more growth but also to less inequality; whether unequal access to finance impacts individual firm growth and household welfare; and whether unequal access to finance in turn reinforces inequality.

1.1. Financial development, growth and inequality

An extensive literature has shown that financial development is correlated with subsequent economic growth (Levine, 2005). A more recent literature investigates whether deeper financial systems contribute to less poverty and inequality, on which theory provides conflicting predictions. Some models imply that financial development enhances growth *and* reduces inequality. Financial imperfections, such as information and transactions costs, may be especially binding on the poor who lack collateral and credit histories. Thus, any relaxation of these credit constraints will disproportionately benefit the poor, improving the efficiency of capital allocation and reduce income inequality by facilitating funding to poor individuals with productive investments (Galor and Zeira, 1993; Aghion and Bolton, 1997; Galor and Moav, 2004). From this perspective, financial development helps the poor both by improving the efficiency of capital allocation, which accelerates aggregate growth, and by relaxing credit constraints that more extensively restrain the poor, which reduces income inequality.

In contrast, some theories predict that financial development primarily helps the rich. According to this view, the poor rely on informal, family connections for capital, so that improvements in the formal financial sector inordinately benefit the rich. Greenwood and Jovanovic (1990) develop a model that predicts a nonlinear relationship between financial development, income inequality, and economic development. At all stages of economic development, financial development improves capital allocation, boosts aggregate growth, and helps the poor through this channel. However, the distributional effect of financial development, and hence the net impact on the poor, depends on the level of economic development. At early stages of development, only the rich can afford to access and directly profit from better financial markets. At higher levels of economic development, many people access financial markets so that financial development directly helps a larger proportion of society.

While the theoretical channels are not thus clear, the empirical evidence is fairly robust

[1] A related review on the theoretical links between finance and inequality is Demirgüç-Kunt and Levine (2007).

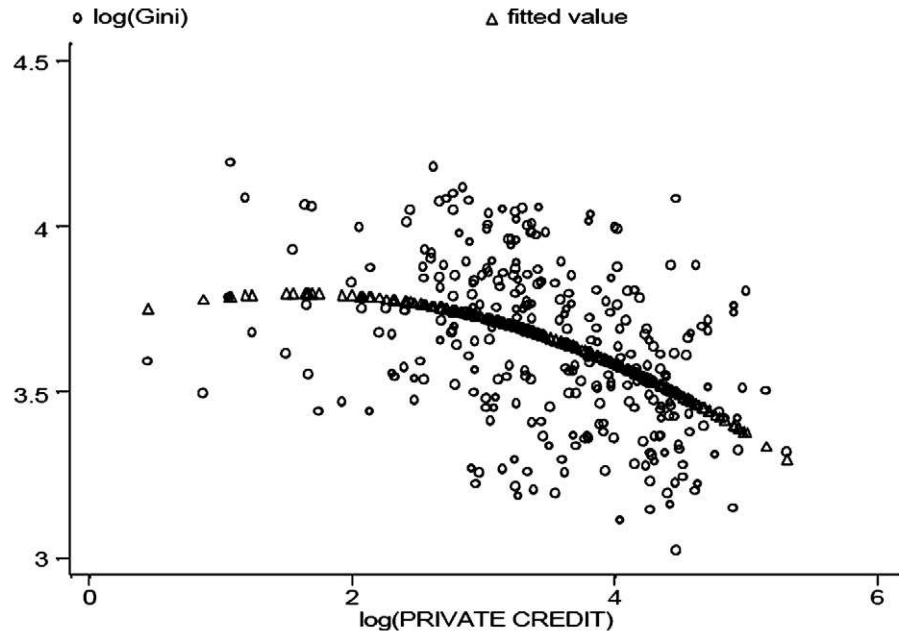
that financial development improves the distribution of income and the incomes of the poor. A convincing analysis on the effect of financial development on poverty is Burgess and Pande (2005). They study a period in India when a commercial bank was required to open four branches in areas without banking presence if it opened a branch in an area with bank presence (the 1:4 license rule). They use this natural experiment to study the impact of access to finance on poverty and output in rural areas. They found that non-agricultural output grew faster and poverty declined more in states with lower financial development in the period 1977–1990, whereas the opposite was true outside this period. They estimate that an one percent increase in the number of rural banked locations reduced rural poverty by 0.36 percentage points and increased total output by 0.55 percent, due to growth in non-agricultural output.

Other cross-country studies look at the link between financial development and poverty and other development objectives.[2] Honohan (2004a, 2004b) finds that aggregate financial depth indicators (domestic credit to GDP) significantly explain poverty in standard cross-country regressions. Claessens and Feijen (2006) show that undernourishment is lower as the financial sector develops. Studying financial development and changes in poverty, Beck et al. (2007a) find that financial intermediary development is correlated with lower income inequality. They show that countries with better financial intermediaries have faster declines in poverty and income inequality, and that financial development reduces income inequality by "disproportionately boosting the income of the poor." Additional evidence finds that inequality decreases as economies develop their financial intermediaries (Clarke et al., 2006).

Figure 1, from Clarke et al. (2006), suggests indeed that more (less) developed financial systems tend to have less (more) income inequality, although the relationship is not linear and there is a lot of variation around it. While the graph only shows the cross-country pattern, there are likely dynamic effects underlying this pattern. Specifically, it is possible that a well-functioning financial system more likely reinforces low inequality, while an underdeveloped financial system reinforces high inequality. As other factors play a role, various types of combinations of financial development and inequality may result, leading to the non-linear relationship depicted. Beck et al. (2007b), for example, find that branch deregulation in the US lowered income inequality, but by affecting labor market conditions, not by providing the poor with greater access to financial services.

Most research to date has focused on the aggregate depth (i.e., size) of the financial system, however, and less attention has been given to the issue of breadth. There can a difference between the depth and the breadth of a financial system, and between the impacts of depth and of breadth. Even if financial depth is associated with more economic growth, when very few firms and households benefit, the resulting growth may be of lower "quality." And when growth fails to renew the set of productive agents, it may be less sustainable and possibly more vulnerable to a backlash. Indeed, recent literature has made clear that inequality reflects not just historical circumstances or (bad) luck, but also a lack of access to economic opportunities, with negative consequences for economic growth (for an general overview see World Bank, 2005a).

[2] Although most of these studies do use instrumental variables, proving causality remains a challenge.



Notes. The fitted line is from a regression of log(Gini) on the log of Private Credit and its square. All data are averaged over seven 5-year periods between 1960 and 1995.
Source: Clarke et al. (2006).

Fig. 1. Log(Gini) against Log(Private Credit) in a panel of 91 countries.

1.2. Inequality in access to finance

Newly available databases (Honohan, 2006; Claessens, 2006b) give some tentative indication that access to financial services can be very unequal. We differentiate here between access and usage of financial services. Usage concerns consumption of services, whereas access is the availability of financial services at a "reasonable cost." As such, access will always be wider than usage. For many countries, only usage data can be measured, and it suggests unequal access for both households and firms.

In higher income countries about 90 percent of households use financial services. In developing countries, access to retail banking services is minimal in the poorer segments of the population, with fewer than one-quarter of households having access to even basic banking services (Honohan, 2006). As we discussed, financial depth and access can differ. While generally deeper financial systems offer greater access, the relation is not universal. As Fig. 2 shows, some intermediate financial systems offer near universal (100%) access while some deeper systems provide relatively moderate access.[3]

The lack of use in lower income countries derives in part from low banking sector outreach, i.e., a limited distribution network in the form of branches, kiosks and other contacts points, so

[3] Financial depth is measured here using the ratio of M2 to GDP, which captures the liability side of the financial system and includes the total deposits held by people in the banking system. The access to financial services measure is the percentage of households that use one or more of the following financial services: payments, deposit, credit or insurance. Data on access are from Honohan (2006); M2 to GDP is from IMF International Financial Statistics.

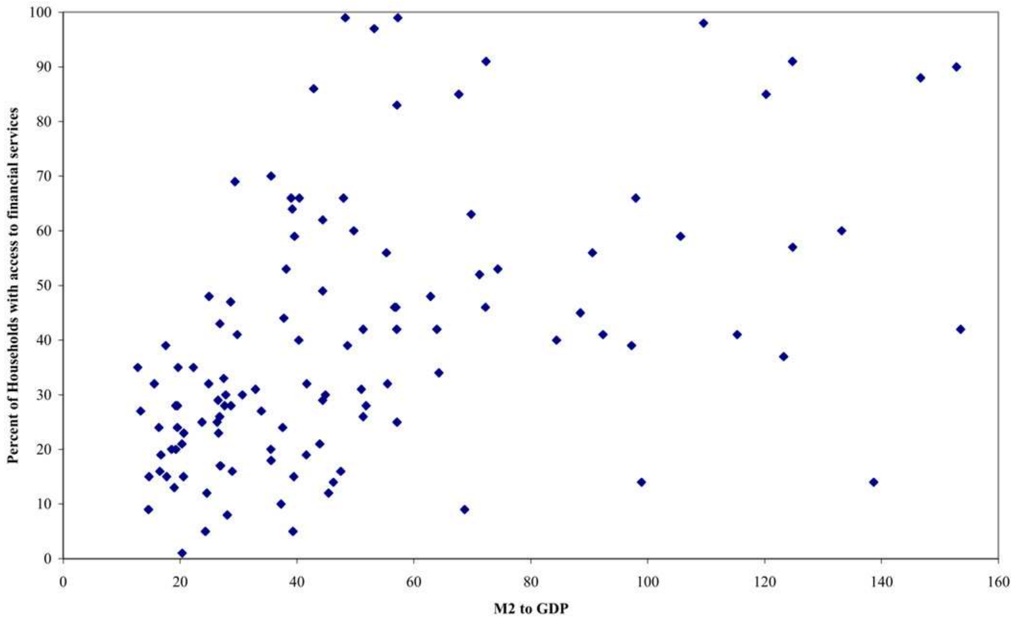


Fig. 2. Access to financial services vs. M2 to GDP: 2005.

that access is quite skewed to the urban, richer segments (Beck et al., 2007c). Numbers on the size of loans and deposits per capita also indicate large disparities among countries. The size of the loan in Uganda is almost 11 times GDP per capita, for example, whereas this ratio is only 1.58 in Israel. The higher average loan and deposit values in lower income countries suggest that only the larger firms and the relatively rich households make use of formal banking services.

The World Bank and other multilateral financial institutions have surveyed enterprises on access to funding through the Investment Climate Assessments (ICA) survey. Complaints about difficulty in getting external financing are highest in developing countries, with on average 29% of firms complaining about lack of external financing being a major or severe obstacle to the operation or growth of their business (Claessens, 2006b). More than 50 percent of firms complain in several countries. The most complaints come from the smallest firms. Differences in complaints between small and large firms across countries varying between eight and twenty percentage points, suggesting that distribution of access can vary greatly.

Related studies indicate that SMEs are in general very credit constrained, that is, they have an unmet demand for external financing. Beck et al. (2005a), for example, show that financing constraints impede growth of small firms more than of large firms (and even more so in underdeveloped financial systems). Beck et al. (2005b) show that industries that should be composed of more small firms grow relatively faster in economies with better developed financial systems. Other evidence suggesting that access to finance largely benefits a few set of firms in developing countries comes from a number of country case studies (Table 1).

Similar to the evidence for households, while generally more developed financial systems have more firms with access to financial services, this is not always the case. The highest share of complaints is 60 percent for Brazil and the lowest 7 percent for Latvia and Lithuania, countries which do not differ much in terms of financial depth, showing that depth and access can be different dimensions. Figure 3 shows more generally that the number of firms that complain

Table 1
Case study and other evidence of finance being captured by few

Country	Evidence	Paper
Brazil	Public financial institutions in Brazil appear to have served larger firms more than private banks have	Beck et al. (2004)
	Campaign contributions led to increased bank financing	Claessens et al. (in press)
Indonesia	Market attributes large value for political connections, suggesting politics rather than economics determined value	Fisman (2001), Leuz and Oberholzer-Gee (2003)
France, pre-1985	Banks, protected and dependent on government support, lend to less productive firms	Bertrand et al. (2004)
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 and took place on better terms than arms'-length lending. Related loans were more likely to default and had lower recovery rates	La Porta et al. (2003)
Thailand	Connected lending was large before 1997 crisis and firms with connections had greater access to long-term debt	Bunkanwanicha and Wiwattanakantang (2006)
	Political relationships reflected in stock prices upon the election of a tycoon as prime-minister in Thailand	Charumilind et al. (2006)
Pakistan	State bank lending mostly benefited politically connected firms	Khwaja and Mian (2005a)
United States, pre-1900	New bank licenses went largely to insiders in New York state	Haber (in press)
Cross-country	Connected companies enjoy easier access to debt financing as well as lower taxation, and higher market share	Faccio (2005)
Cross-country	State bank lending mostly benefited sub groups, such as the largest SOEs and their employees	La Porta et al. (2002), Barth et al. (2000), Dinc (2004), Faccio (2005)

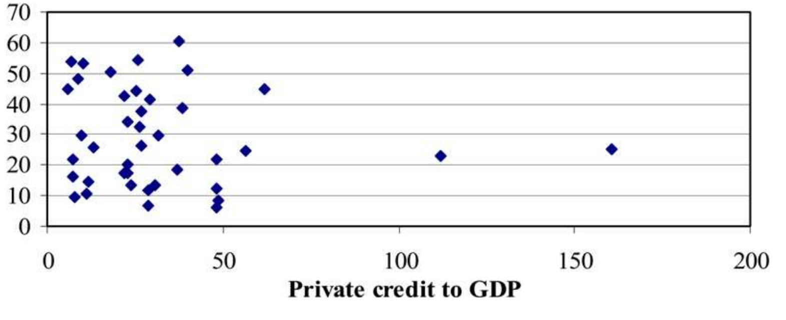


Fig. 3. Individual firms' access versus overall private credit (% of firms that complain about lack of financing).

about lack of financing generally declines as financial development—measured by private credit to GDP—increases, but the relationship is not strong.[4]

[4] Data on complaints by firms on lack of financing are from Claessens (2006b); private credit to GDP is from IMF International Financial Statistics.

1.3. Effects of inequality in access to finance

Firms consistently need to bribe officials to avoid regulatory harassment in developing countries (Berger and Udell, 1998), all the more once they join the formal sector. As money is fungible, access to funding can help overcome most barriers. Recent evidence is showing the importance of access to finance for less established producers. In a large study of entry rates across countries, Perotti and Volpin (2007) show that better investor protection is indeed correlated with larger average entry rates, as well as with more firm density in sectors which depend more on external finance. This confirms that poor financial access is a major source of entry barriers. Their results indicate that poor investor protection is more likely in countries with poor political institutions, and in countries with greater economic inequality. Interestingly, they find that while the size of domestic capital markets contributes to explain entry, it is no longer significant once they introduce effective investor protection. Thus individual access to finance is more critical for new entry than the general state of financial markets.

Another empirical study focusing on firm data (Ayyagari et al., 2006) shows that, in directly affecting their growth, access to finance ranks as one of the top three barriers for growth—the other two being crime and political instability—with finance as the most robust of the three.[5] Limited finance appears to hurt smaller firms more compared to their larger counterparts. Estimates of the effects of lack of financing constraints suggest that small, medium and large firms have grown slower by 10.7, 8.7 and 6.0 percent respectively in the period 1996–1999 (Beck et al., 2005a). This lower growth suggests that lack of access to financing increases indirectly inequality.

Unequal access to finance can be such a barrier to economic opportunities as it reduces entrepreneurial activity, itself an important determinant of economic success. Entrepreneurs who fail to raise funding tend to operate in the informal sector where they produce at suboptimal levels, even though they may show high productivity of capital investment. Accordingly, financing constraints to investment for small firms are argued to be one of the main causes for lack of convergence in growth rates between rich and poor countries (Banerjee and Duflo, 2005).

In terms of individuals' welfare, new evidence shows that financial development and access to finance can improve economic and social inequality indicators, such as the prevalence of hunger, poor health, low education and gender inequality (Claessens and Feijen, 2007 review). Micro-finance, which has become extremely popular in the past decade, has been an important component of the way to increase access to finance for the poorest. At the same time, systematic, statistical research on the effects of increased access to micro finance on welfare, inequality, poverty at present is for the moment qualified. Many studies suffer, for example, from selection effects, where the more talented or otherwise well-endowed households that actually got the loan, might have prospered even in its absence. More research is needed to assert whether there is a robust and positive relationship between the use of micro credit and household welfare, including moving out of poverty (see Armendariz de Aghion and Morduch, 2005 for a review of the evidence on micro-finance).

[5] Some of these barriers are of course correlated. Gordon and Li (2006), for example, argue that in developing countries, governments are in practice only able to collect taxes from those firms that make use of the financial sector. High taxes on a small, repressed formal corporate sector with some, but limited access to finance can then be a second-best policy. Empirically, this would mean that differentiating (across countries) tax barriers from access to finance barriers is more difficult.

In conclusion, the available evidence is that financial access is quite skewed, and affects enterprise growth, competition and individual welfare. Lack of diffused access can undermine growth, reduce welfare and create vulnerability to financial crises. So why have financial sector reforms not been targeted at improving the access to financing? We argue that the answer may lay in the initial level of inequality, and its effect, or even simple correlation, with unequal access to political influence.

2. Why may access be unequal?

The evidence reviewed so far suggests that many financial systems provide unequal access to households and firms and that financial underdevelopment hurts some agents more than others. Unequal access can arise because of some *natural economic reasons*, such as natural high *fixed costs* in offering financial services, or because of barriers created by entry *regulations* that serve a valid public good (e.g., identification requirements for opening up a bank account to maintain financial integrity). But unequal access can also arise out of *political influence* which creates regulatory obstacles to protect established rents (Acemoglu et al., 2005; Rajan and Zingales, 2003a). In countries with poor political institutions, economic inequality naturally leads to unequal political influence. Powerful groups will affect the regulatory and judicial environment, and often control the allocation of finance (directly through bank ownership, or indirectly through political connections). We consider these three causes—natural and regulatory barriers, indirect control, and direct control—in order.

2.1. Natural economic and regulatory barriers

Unequal access to finance may arise in any market, developed or developing, due to some objective, natural constraints, such as high fixed costs which reduces profitability of serving the poor, or due to barriers created by the regulatory environment serving a valid public good. Financial institutions often claim, for example, that the fixed cost of providing small-scale credit is high. This may be because of high fixed costs of screening or subsequent monitoring, or the high costs of enforcement.

One could counter that provision of financial services for some groups is poor even in developed financial markets where institutional environments are good, competition generally high, and technology not a major barrier. financial market imperfections—such as information and transactions costs—are likely to be especially binding on the talented poor and the micro and small enterprises who lack collateral, credit histories and connections, limiting opportunities. For example, in the model of Galor and Zeira (1993), it is because of financial market frictions that poor people cannot invest in their education despite their high marginal productivity of investment (see also Banerjee and Newman, 1993) Another explanation of uneven financial development in developing countries could be their high concentration of economic activity which makes it more difficult for financial institutions to grow by diversifying risks (Ramcharan, 2006). But lack of productive diversification may be endogenous to limited financial access.

It is not clear a priori whether agency costs are highest for poorer social groups, given the evidence on financial repayment by large and politically connected firms. But lack of service provision for lower segments extends to many non-credit services which do not involve default risks, have less need for screening, and have low transaction costs. Payment services, for example, are often not available, or only at high costs, for low-income households. At the same time successful experiences in many countries indicate that some of these barriers can be overcome. The informal lending arrangements used by many successful micro-finance institutions suggest that fixed costs or other economic and technical reasons cannot fully explain the lack of access to financial services for some groups. Reliance of micro credit on social enforcement for ensuring repayment, for example, reduces monitoring costs. Indeed, specialized microfinance institutions have reached millions of clients and the largest of them have achieved impressive repayment rates, especially when compared with the disappointing record of an earlier generation of development banks (Robinson, 2001). At the same time, some of the stronger micro-finance institutions have secured banking licenses and offer a wider range of services to a broader clientele.

While some micro-finance institutions have graduated beyond the need for sizable subsidy, others still seek subsidies to help keep the costs to the borrower to a minimum. Data on their profitability and sustainability suggest that a large proportion of the institutions still depend on subsidies, leaving open how financial sustainable micro-credit may be. Looking at 124 microfinance institutions in 49 countries representing around 50 percent of all microfinance clients around the globe, which most likely include the more efficient ones, Cull et al. (2007) find that only half of them were profitable. One of the reasons might be lack of scale; only in eight countries do microfinance borrowers account for more 2 percent of the population (Honohan, 2004b). On the other hand, as micro-finance institutions grow and mature, they seem to focus less on the poor (Cull et al., 2007), which could be interpreted either as success story for their borrowers or as mission drift. Rajan (2006), who reviews more broadly the experiences with micro-finance institutions, concludes that the micro-finance industry has to follow the clear and unsentimental path of adding value and making money to sustain itself.

Recently, some commercial banks in developing countries have started to challenge the notion that banks cannot cater to poor clients. While the experiences are recent and there is as of yet little evidence that they are sustainable, they offer the promises of increased access through better technology. The case of ICICI bank in India, for example, suggests 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 by innovative solutions (such as mobile banking units; see further (Ananth and Mor, 2005; Napier, 2005) describes similar experiences for the case of South Africa). Simpler banking products and prepaid cards for small transactions can lower thresholds. Foreign banks in developing countries have shown to be able to lend and widen access in spite of a weak-contracting environment, although for selected purposes and selected groups.

In conclusion, many barriers to a broad access to finance appear to be related to a poor institutional environment. This raises the critical question of the direct influence of institutions on access. In many developing countries, enforcement costs are high because of low investment in judicial infrastructure serving the poor. This may be neglected purposely to avoid a more diffuse access to productive opportunities. Rules on individual identification for opening up a deposit in a bank are often said to be cumbersome and discouraging access (see further Beck et al., 2006a).

The large, but seemingly unnecessary barriers to access to financial services mimic those in the more general business environment. Recent empirical studies have highlighted the entry barriers and post-entry regulatory costs encountered by individual businesses in productive activities (Djankov et al., 2002). 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. These formal barriers could represent optimal regulatory arrangements to protect consumers or ensure stability. Evidence, e.g., World

Bank (2005c), however, shows that entry costs and barriers for business are often more onerous and higher in poorer countries, suggesting that they retard growth rather than serve efficient purposes. Indeed, Klapper et al. (2006) present evidence that these formal barriers mostly do not serve efficiency purposes.

Specific evidence of the costs of many regulations for financial sector development, e.g., entry and activity restrictions, in terms of lower credit market development and less bank stability, comes from Barth et al. (2006). In general, many complex formalistic rules appear just designed to create opportunities to extract bribes, the so-called tollbooth hypothesis (Shleifer and Vishny, 1998). Informal barriers add to these costs and include vague rules and frequent inspections aimed at extracting bribes, and biased regulatory and contractual enforcement favoring established producers. Indexes of formal and informal barriers are indeed correlated with corruption measures (Djankov et al., 2002).

Entrepreneurs can escape formal barriers, high taxes, and onerous requirements by remaining in the informal sector. This choice however condemn them to a limited economic role, as it undermines their access to finance, limits their trade opportunities, and keeps them dependent on established firms. Furthermore, it reduces their voice in economic and political decision-making. Thus barriers to economic participation often ultimately favor insiders and lead to persistency in inequality.

A critical question still is why would inside agents block beneficial (financial) reforms. After all, the evidence coming from the growth-financial development literature shows that the economy in general, and presumably the insiders as well, would forgo some faster growth by blocking beneficial financial reform. The answer offered in the new political economy literature is that reforms that lead to efficiency gains also shift power away from the elite, and will there fore be resisted (Acemoglu et al., 2005; Acemoglu, in press).

Rajan and Zingales (2003b) discuss this regulatory capture argument, and show that a country being more open to trade and financial flows can reduce the political resistance to generating barriers, including in the financial sector itself.[6] Regulatory capture and its effect on access to finance and entry is explicitly modeled by Perotti and Volpin (2004), where established interests seek low investor protection to hold back new competitors. Lowering entry reduces welfare, so lobbying for low investor protection requires political contributions ("bribes"), which lobbyists trade off against their gains from entry restrictions. The theoretical result is that greater political accountability increases the bribe required by legislators to restrict entry, and thus induces lobbyists to accept more competition and higher entry. Their empirical tests confirm the role of political institutions on financial access. Countries with more accountable political regimes, namely in countries with more private scrutiny on the executive, have better investor protection. This effect appears complementary to legal origin and persists even after controlling for GDP per capita, used here as a summary statistics for overall institutional quality. Interestingly, the best explanatory political variable to explain access to finance turns out to be not a formal characteristic of democratic participation, but newspaper readership. This result reinforces the notion that accountability of political institutions is less served by formal mechanisms of power sharing and more by broad awareness of policy choices and outcomes.

New evidence of how economic inequality leads to political influence on the financial sector and over financial reform is starting to emerge. Bordo and Rousseau (2006) study 17 countries

[6] Braun and Raddatz (in press) show that in countries where trade reform increased the gains from access to finance for non-incumbents, incumbents were more likely to oppose financial reform.

over the period 1880–1997. After controlling for initial per capita income and legal origin, they find a strong, independent effect of proportional representation, frequent elections, female suffrage, and political stability on the size of the financial sector. Barth et al. (2006) study a cross section of 65 countries in 2003 to explore the impact of constraints on federal executives, the competitiveness of elections, and government accountability on bank entry and bank regulation. They find that countries with more open, democratic institutions tend to be more permissive of bank entry and tend to create fewer regulatory restrictions on banks.

In general, countries with tighter regulatory have less credit market development and, remarkably, lower bank stability. Their regulatory frameworks tend to discourage private monitoring necessary for the dissemination of independent information, a necessary condition to maintain political control over the allocation of capital. These countries also tend to use government-owned banks to direct credit toward the interests of the politically powerful, to limit competition in banking in order to protect incumbent banks, and to create regulatory restrictions so that bankers need to lobby politicians for special exemptions. In short, there appears to be a strong association between strict regulatory constraints limiting financial development and entrenched established interests which lobby to limit entry and forestall competition.

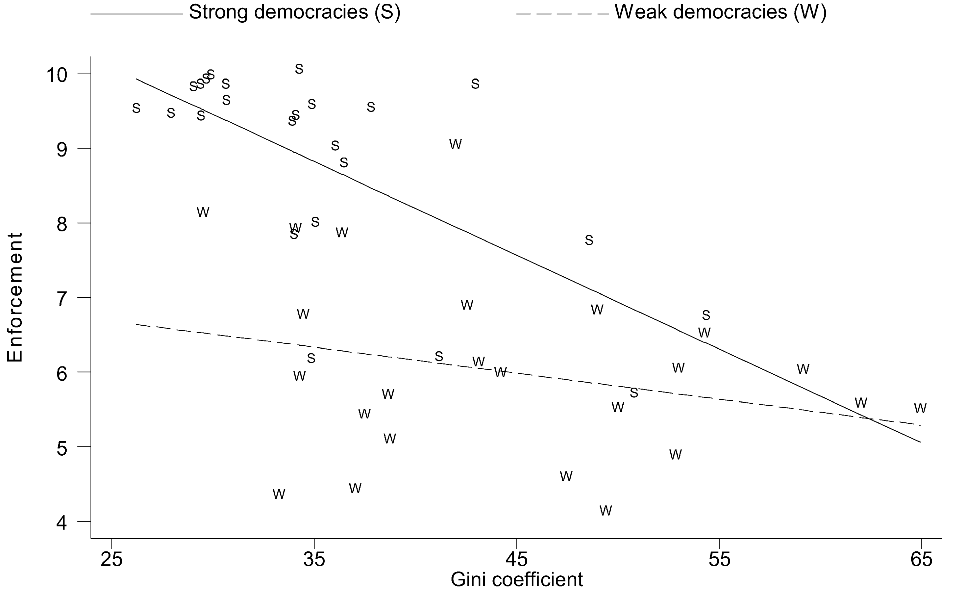
The impact of politics on access to finance may be quite direct, resulting from political control on the allocation of finance. Countries with fewer constraints on political power have more politically connected lending (Faccio, 2005). Politically connected lending tend to favor larger firms (Faccio et al., 2005). Remarkably, connected firms obtain larger loans at the same cost, but have a much worse track record of repayment (Khwaja and Mian, 2005a). Beck et al. (2006b) show that powerful supervisors are associated with more corruption in lending, thus providing evidence for the private capture view and against the public interest view.

A critical factor of indirect control over the allocation of financial resources is that it can be exercised stealthily, avoiding public scrutiny or distorting reality, more so than in other sectors. Purposely unclear regulatory lines, for example, can be justified on overlaps between public and private interests (such as the special nature of banks for monetary stability). Limited transparency and tight entry regulations can be defended as helping financial stability. Personal relationships can be seen as being needed given the specialized nature of financial businesses. Yet low transparency allows government-owned banks to direct credit toward the politically powerful, easily limit competition in banking in order to protect incumbents, and create regulatory restrictions so that bankers need to lobby politicians for special exemptions. There appears to be a strong cross-country association between strict regulatory constraints limiting financial development, poor transparency and regulatory capture aimed at limiting entry and forestall competition.

The most powerful indirect tool to undermine access is weak enforcement of private contracting, such as poor creditor and equity rights protection. As suggested by De Soto (2000) and shown in cross-country regressions, poor legal enforcement and unclear property rights limit individuals' ability to commit contractually, secure assets and thus to raise funding. The literature on law and finance (La Porta et al., 1998, 2006) has established that in countries with larger capital markets and better protection of investors, markets are wider, ownership more diffused, with more listed firms and more public offerings. Djankov et al. (2006) show how both creditor protection through the legal system and information sharing institutions are associated with higher ratios of private credit to GDP, but that the former is relatively more important in the richer countries.

In turn, the quality of property rights can be in part a function of the distribution of wealth. Morck et al. (2005) review how extensive control of assets by a few families can distort capital allocation and reduce innovation. Morck and Yeung (2003) indeed show a strong correlation, though not necessary causation, between the degree of family control and measures of entry barriers, judicial system inefficiencies and political and tax system corruption (see also Chong and Gradstein, 2004). Differential access to finance becomes critically visible in times of financial stress. Boone et al. (2000) find that the drop in exchange rates and stock markets in 25 emerging economies during the Asian Financial Crisis of 1997–1998 is better explained by the quality of their corporate governance than by conventional explanations of inappropriate macroeconomic policies, such as exchange rate policy, government borrowing or exuberant lending by international banks.

Democracy could, in principle, break the chain of the argument by allowing more equal political influence regardless of economic conditions. Cross-country evidence, however, suggests that while the strength of democracy affects the links between inequality and political influence, there still remains an effect. Figure 4 depicts for countries with strong and weak democracies the relationships between the degree to which property rights are enforced, an important means by which insiders retain control, and the degree of inequality in the country.[7] For a given level of (income) inequality, enforcement is much better in strong democracies, suggesting that an accountable po-



Source: Perotti and Volpin (2007).

Fig. 4. Enforcement and inequality for highly and poorly accountable political systems.

[7] The figure is based on the analysis of Perotti and Volpin (2007). The Gini coefficient of income inequality is for the 1964–1983 interval and comes from the World Bank World Development Indicators and other sources. It ranges between 0 and 100 (a greater number indicates greater inequality). Enforcement is measured as the average of the five enforcement variables produced by La Porta et al. (1998): efficiency of the judicial system, rule of law, corruption, risk of expropriation, and risk of contract repudiation. It ranges between 0 and 10 (a greater number indicates stronger enforcement). Democracy score is the average score produced by Polity IV for the 1964–1983 interval. It ranges between 0 and 10 (a greater number indicates more democracy). Countries are divided into strong and weak democracy depending on their score being above or below the median.

litical system mitigates the relationship between economic inequality and the political influence over enforcement systems.

More powerful than the cross-country evidence, which remains challenging in terms of attribution of causes and effects, may be the evidence from case studies highlighting the impact of entrenched elites over institutional environment important for the financial system. Haber (1991) shows the differential impact of (lack of) concentrated industrial wealth through its effects on the institutional environment on capital market development in Brazil, Mexico and the US. Kroszner and Strahan (1999) show the role of politics in the relaxation of bank branching restrictions in the US. Glaeser et al. (2003) argue that for the US during the Gilded Age (1865 to 1901) and Russia in the 1990s, the subversion of legal, regulatory, and political institutions by the powerful led (eventually) to important adverse effects of inequality on economic and social progress. Similarly, influential business groups and large, connected conglomerates in East Asia seemed to have played a perverse role in the countries' institutional environments (Claessens et al., 1999).

2.2. *Direct control*

Direct control of the financial system allows control over investment opportunities or new entry which require external financing. Joint control of financial institutions and corporations, and related lending has been the most common form of direct control in emerging markets. This produces a specific type of financial market, often dominated by large, family-owned business groups. The diffusion and maintenance of highly diversified family-owned groups in emerging countries (Khanna and Palepu, 1998) is a summary piece of evidence which suggests a concentration of investment opportunities in few hands not obviously connected with specific competences or open competition.

Joint control and related lending can in principle be interpreted as a second-best response to a weak property rights and poor informational environment, and could therefore be overall beneficial. Cull et al. (2006) show that related lending helps in environments with good institution, but hurts in environments with poor institutions. In practice, though, related lending has most often benefited only a few and has led to poor resource allocation as many case studies show (see Table 1 for relevant research). La Porta et al. (2003) find for Mexico that related loans are 33 percent more likely to default and, when they do, these loans have lower recovery rates (30 percent less) than unrelated ones. Furthermore, the fraction of related lending almost doubled for 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 to moral hazard problems. Khwaja and Mian (2005a) report similar evidence of higher default rates on loans to connected firms for Pakistan, with politicians exercising large influence. There is similar evidence of Russian connected lending following financial liberalization at a large final cost to small depositors and the government (Laeven, 2001; Gelfer and Perotti, 2001; Perotti, 2002).

Besides direct control over financial institutions, elites can exercise influence on financial allocation. In some countries, the influence can be very direct, as in case of state-owned banks when the political elite overlaps with the corporate and the financial sector elite (e.g., Indonesia under Suharto, the Philippines under Marcos). State bank lending, which could in principle compensate unequal access, has generally been found to be inefficient (La Porta et al., 2002 and Barth et al., 2000; Sapienza, 2004) and mostly benefited sub groups, such as the largest SOEs and their employees (Dinc, 2004 and Faccio, 2005) or politically connected firms (Khwaja and Mian, 2005a). Evidence on how state-owned banks use credit for political purposes can be found in Cole (2006). Evidence on the ex-post performance on this lending also suggests considerable preferential treatments, with losses on larger loans particularly high in weak enforcement countries. Zia (in press) shows that subsidized export loans in Pakistan were misallocated in favor of politically connected parties. Credit lines extended by international agencies through government agencies are mostly targeted to large firms (World Bank, 2005b), likely due in part to their political influence.

To what extent can financial liberalization reform such a tight grip of regulators and established interests on the allocation of finance? There is evidence on mixed effects of capital account liberalization. Bekaert et al. (2006), for example, show that consumption volatility decreases after financial liberalization only in countries with good political institutions. They conclude that "political factors are more important than legal factors in driving consumption growth volatility." Bulgaria, Czech Republic, Mongolia, Russia and other transition economies show how a voucher scheme privatization scheme easily gets high-jacked by insiders. Beck and Laeven (2006) show that natural resource dependence and too much time under socialism has hurt institution building after transition. More generally, many transition economies witnessed the capture of state resources or protected rents by their elites (Black et al., 2000 and Johnson et al., 2002). We turn to this theme in the next section.

3. Financial reform in the context of inequality

In many cases financial liberalization reforms lead to economic growth, and certainly in the short term they produce credit expansion and more investment. Yet there have been many examples where reforms has been followed by increased instability. Large crises have worsened inequality and created negative responses to liberalization, ultimately undermining political support for reform. How to account for this variation in outcomes of financial reform? To shed some light on this question, we review experiences regarding financial sector reform, stressing choices on *timing*, the *allocation of assets, rents and growth opportunities*, and the *distribution of risks*. We argue that these experiences show how the structure of a country's political system can either undermine or support the quality of financial sector reform, the transition towards broader financial access and the maintenance of political support.

3.1. Timing

The experience of financial liberalization in developing and developed countries over the past two decades has been much studied (e.g., Williamson and Mahar, 1998; Henry, 2003; World Bank, 2001; Chinn and Ito, 2005; for a review see Levine, 2005). There is much evidence, especially individual firm level evidence, that domestic deregulation and liberalization have increased the supply of domestic capital, attracted foreign capital, contributed to a lower cost of capital, led to more relaxed financing constraints, etc. In turn, this has led to increased investment and growth, at least in the short to medium term and on average.

Capital market liberalization specifically has been found to have in general a positive effect on average on growth, asset allocation and efficiency (Henry, 2000a, 2000b; Levine and Zervos, 1996; see Bekaert and Harvey, 2003 and Henry, 2006 for reviews). Banking system deregulation has similarly been found to generally improve financial system functioning and widen access (Barth et al., 2006). In addition to the general evidence that deregulation can help with access, there is specific evidence that allowing greater entry by foreign banks can further enhance access. A study on loan distribution for Latin America found that foreign banks with small local presence do not appear to lend much to small businesses, but that large foreign banks in many cases surpass large domestic banks (Clarke et al., 2005a). This conclusion is not uncontroversial though. Gormely (2006), for example, provides evidence for India on the impact of financial openness on capital allocation and investment at the micro level, consistent with the exacerbation of information asymmetries upon foreign bank entry (see also Detragiache et al., 2006). (Evidence on the effects of foreign bank entry is reviewed in Clarke et al., 2003.)

Yet evidence of resistance to valuable reforms or attempts to distort their design is also abundant. General analysis (Roland, 2000) suggests that economic reforms tend to occur when no other options are left and when the costs of not doing so become too high, suggesting that political economy factors are important. Even though a distorted institutional environment associated with unequal wealth concentration ultimately hurts growth, often established interests do not seek to improve the institutional environment as this may undermine its own influence.

Acemoglu and Robinson (2006) show that because reforms, or at least some type of reforms, undermine the mechanisms by which the elite exercises control, output-enhancing reforms become unattractive. When the comparative advantage in entrepreneurship shifts away from incumbents over time, making new entry more attractive for growth, the resistance of the elite to reforms is actually reinforced as they fear loosing control. In the end, they may find the certainty of a large stake in a smaller pie better than a small slice of a larger pie. A similar effect exists in the diffusion of education that can lead to economic invention and growth. This diffusion may be resisted if it promotes political participation and weakens control structures (Bourguignon and Verdier, 2000).

Evidence from private sector and financial sector reforms is similar.[8] Laeven and Perotti (2002) show that privatization programs are usually only started during fiscal and economic crises. Boehmer et al. (2005) show that in developing countries bank privatization occurs when the government is more accountable and more right-wing, but also when the economy is doing poorly. And they show that in developed countries privatization is more likely when the fiscal situation is worse. Clarke and Cull (2005) show that poor performance of Argentina's provincial banks made privatization more likely. Large, overstaffed banks in provinces with high levels of both unemployment and public sector employment were less likely to be privatized. Beck et al. (2005c) show that Brazilian regional banks were privatized only when the costs to the local governments of continuing to use them for political purposes became too high (for a further review of experiences with bank privatization, see Clarke et al., 2005b). The mass-privatization of state-owned enterprises in the Czech Republic, accompanied by maintained state influence on banking, allowed insiders to delay the establishment of a securities and exchange commission, thereby facilitating tunneling. Only when a balance-of-payments, financial and political crisis ensued did the government act and create an SEC (Cull et al., 2002).

3.2. Allocation of assets, rents and growth opportunities

Reforms often benefit insiders through preferential allocation of assets, rents and growth opportunities. Many privatization of state-owned banks happened to groups of insiders. Case studies—Mexico in the 1980s (Haber and Kantor, 2004; Haber et al., 2003; La Porta et al., 2003), Chile in the 1970s (Velasco, 1988 and Valdes-Prieto, 1992), and Russia in the 1990s (Claessens and Pohl, 1995 and Perotti, 2002)—are most illustrative here as they best show the many means

[8] For a cross-country analysis of the determinants of financial sector reform, see Abiad and Mody (2005).

used to skew the gains from financial reform. Mexico privatized its banks in the late 1980s in suspicious auctions which excluded foreigners and allowed politically connected groups to acquire control. A nationalistic argument was used to allow these acquisitions to be funded with borrowed funds, often from the acquired banks themselves. The banks went on to a rapid expansion of credit, much of it to related parties, which ended up in a massive banking crisis which cost the Mexican taxpayers over 80 billion US dollars. The privatization of state owned banks in the late 1970s in Chile was similar and had the further effect that a few well connected families could use bank resources to acquire many other state owned firms.

Another way has been the preferential allocation of licenses. Apart from local interests preventing foreign entry (see Clarke et al., 2003), licenses have often been directed to insiders, as in Indonesia (for banks) and Thailand (non-bank financial institutions). In Korea, for quite some time only chaebols were allowed to open non-bank financial institutions (Haggard et al., 2003). In general, unnecessary high capital requirements for new banks can be seen as a policy designed to benefit insiders, but its extreme opposite is also effective. Russia's choice of a universal banking structure and extreme loose requirements facilitated asset stripping, and bank lobbyists bribed, intimidated and even murdered brave enforcement officers, while buying parliamentary support (Perotti, 2002). Remarkably, following a major liberalization shift, talented public officials who designed the new policy join the private sector, undermining enforcement capacity and creating scope for connected policy choices.

Reforms often led to established, well-connected individuals capturing much of the gains from the new opportunities. The benefits of stock market liberalization appear to be particularly highly concentrated: after liberalization, the growth in income 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 (Das and Mohapatra, 2003). Poor regulation and weak enforcement in many liberalizing markets allowed insiders ample space for the expropriation of minority shareholders (La Porta et al., 2000; Claessens et al., 2002; see Claessens, 2006a for a review of corporate governance in developing countries). Listing and corporate governance rules were often designed to benefit insiders. Khwaja and Mian (2005b), for example, show evidence of insider abuse following mutual funds reform in Pakistan.

While increased financial openness generally improves capital allocation and investment at the micro level (Henry, 2003), it does not necessarily translate into higher economic growth at the aggregate level. Prasad et al. (2006), for example, find that non-industrial countries that have relied more on foreign finance have not grown faster in the long run. At the same time, capital account liberalization has occurred mostly in countries with higher income inequality, suggesting political economy factors driving them (Quinn, 2000). And cross-country evidence suggests that increased capital mobility after liberalization leads to greater income inequality (Brilman, 2002). Capital account convertibility introduced in many Latin America and African countries surely has facilitated capital flight to offshore accounts favoring the rich. Siegel (2003) finds that increasing openness in Korea primarily strengthened the more politically connected firms.

3.3. Allocation of risks

Liberalization and financial reforms can create financial risks. How large they become, how they are managed, and the consequent distribution of gains and risks often depends on the political economy. In many countries, systemic crises have brought heavy tolls, facilitated by moral hazard brought on by the public safety net for banks. The chances of post liberalization crises have been shown to be a function of the degree of inequality and weak political accountability, reflecting unequal scrutiny of the reform process.[9] Bongini et al. (2001) show how connections of East Asian banks with industrial groups or influential families increased the likelihood of distress, suggesting that supervisors had prior granted selectively forbearance from prudential regulations.

In most cases banking crises' costs have been socialized, often in a highly regressive fashion. Dooley (2000) goes as far as arguing that financial crises are mainly manifestation of underlying political processes aimed at "stealing" from the government (by insiders). Galbraith and Lu (1999) find that crises typically generate increases in inequality, and more so in less developed countries and in regions that are more liberal in their policy regimes. In Chile, the highly leveraged business groups created after liberalization were quite exposed to foreign borrowing, and collapsed in the early 1980s when international interest rates increased. Again, tax payers bailed out the insiders. The redistributional consequences of the Indonesian and Russian crises have been similar. Especially in countries with poor institutional environments governments have tended to allocate losses to groups according to their power positions. Financial transfers during crises in Latin America, for example, have been large and, usually being targeted to richer households, have increased income inequality (Halac and Schmukler, 2004). This problem is not limited to developing countries, however, as the discussion on looting during the US S&L crisis shows (Akerlof and Romer, 1993).

The redistributive impact of crises is not necessarily on the poorest segment, who hardly participate in the formal economy and have little to lose. More often they hit the lower middle class. Bosch et al. (2004) found that in Mexico during 1992–1995 households headed by the less well educated (poor), single mothers or those in the informal sector did not experience a disproportionate loss of income. Yet overall poverty does rise in financial crises (Manuelyan-Atinc and Walton, 1998). Diwan (1999) finds that the labor share in GDP sharply falls following a financial crisis, recovering only partially in subsequent years, suggesting that the resolution of crisis involves changes in distributions favoring capital and connected insiders, and harming labor.

The redistributive impact of financial crises on firms appears to be affected by weak institutional environments, and result in reduced capacity and less competition. In general, sectors which depend more on external finance are harder hit (Laeven et al., in press). Yet the impact is not felt uniformly in countries with poor institutions and more corruption. Sectors with more small firms suffer more during financial crises, especially in developing countries (Dell'Ariccia et al., in press). Feijen and Perotti (2006) model explicitly how lobbying by established firms may weaken access to refinancing for smaller or less capitalized firms needed to survive large shocks, resulting in excess exit. They present evidence of higher exit rates after crises in sectors where young firms are more financially vulnerable. This cushions profits for more established producers, which presumably also benefit from forced asset sales due to diffused bankruptcies. As a specific example, the Russian financial crisis of 1998 was followed by a sharp increase in industry concentration.

When crises resulting from captured reforms increase inequality, then the very sustainability of reforms is affected. Liberalization is more likely sustainable when it broadens the set of feasible opportunities for many citizens; otherwise, it can produce a political backlash. Obviously,

[9] Large financial crises are more likely in countries with worse institutions or poor transparency, see Demirguc-Kunt and Detragiache (1998), Mehrez and Kaufmann (1999), Keefer (2001), and Acemoglu et al. (2003).

the political system the country has, can change the form in which the backlash may occur, although the final outcome is hard to predict. Glaeser et al. (2003) argue that in many countries the political response to institutional subversion by the rich is not institutional reform, but rather a form of massive Robin Hood redistribution. In some cases, this backlash dramatically slowed economic and social progress. In other cases, the effect was simply a change in the elite.

Politicians may still choose to implement opportunist reforms, even in the anticipation of a backlash because of their short-horizons, the ease of hiding the financial costs, or their ability to blame other causes. Political control over banks is particularly likely to be used for such short-run political purposes. 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, 2004). In many cases, the financial sector is an ideal place to exercise control and plunder, as costs and benefits may not be immediately observable and the process is far from transparent. Failed banks, for example, are less likely to be taken over by the government or lose their license before elections than after (Brown and Dinc, 2004), suggesting financial costs can easily be hidden.

4. Conclusions

We reviewed the evidence on the links between financial development and inequality, and argued that these links appear to arise largely from the influence that the political and economic elites exercise over a country's institutional environment. Reviewing cross-country and case evidence, we show that there is unequal access to external finance across countries, that financial underdevelopment hurts some agents, that unequal access to financial services can arise out of political influence on the financial sector and over financial reform, and that economic inequality may undermine the long-term feasibility of (financial) reform. In countries with historically high inequality, distorts the institutional environment, produces unequal access to finance, and ultimately leads to unequal opportunities, which in turn reinforces any initial economic inequality.

It is important to distinguish here between different types of inequality. Morck et al. (2000) 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 when inherited billionaire wealth is larger as a fraction of GDP. While not strong causal evidence, it nevertheless suggests that growth itself is not undermined by large success of capable entrepreneurs, but can be hampered if it leads to a process of defending established rent positions.

Research on this theme has had so far only limited policy impact and leaves a number of questions open. If inequality makes captured control over the financial system more likely, is there a role for financial reform at all in unequal developing countries? Can financial liberalization resolve the problem of privileged access, or does it actually aggravate the inequality problem? When do reforms become sustainable? How does the political regime affect the various links and can (more) democracy alone allow for equal political influence regardless of economic conditions? While we have limited formal analyses or robust evidence, we can speculate as to what is needed to make financial reform welfare enhancing for all, or at least for most citizens. Four issues come to mind.

First, there is some evidence pointing to a critical threshold of the development of political institutions for financial reform to be successful. The evidence suggests that some political accountability is a critical factor determining the success of financial reforms. In some countries, private capture of reform was limited due to external anchors, such as the EU in case of Central and Eastern Europe (Roland, 2002). Possibly other external commitment devices, such as trade and other WTO (financial service) agreements, can play this role for countries today.

Second, even when inequality increased in rapidly growing countries, its political consequences can be muted when growth is driven by entry in a context of open competition. McMillan and Woodruff (2002) show how the most successful transition countries were those where entrepreneurs were given more chances to achieve economic success in an open environment. In China, sufficient access to (informal forms of) finance and general ease of entry has allowed many new firms to take off. Although politicians have captured some of the gains, their willingness to support entry rather than monopolizing it, in sharp contrast to Russia, has maintained popular support. A dual track approach, slowing down the decline of old sectors, may have further mitigated the concerns of established interests. In contrast, in Russia, growth has been more linked to natural resources, creating rents which have not been shared widely. A general perception of massive abuse of market reform under Yeltsin, and capture of economic opportunities by few individuals, has led to a re-centralization of economic governance, which appears to have shifted the identity of the beneficiaries from politically connected private entrepreneurs to state officials. The experiences of privatization and financial liberalization in several Latin American countries have similarly often failed to build broad support for free markets, as insiders reaped more of the gains and created little new activities. The negative effects of privatization on inequality have had repercussions on public support for privatization and reform in Latin America (Birdsall and Nellis, 2002), and may have contributed to a wave of more populist politicians being elected.

Third, it is important to distribute broadly the early benefits of reforms. Targeting of benefits may be adopted, as discussed in Biais and Perotti (2002) in the context of mass privatization programs. In a democratic setting, inducing median class voters to buy privatized enterprises by underpricing shares may shift political preferences away from redistribution-oriented parties. Chile represents a good example where ownership was deliberately more widely distributed following the 1979 financial crisis, leading to more support for reform and a market economy (and democracy) In India, a democracy, some interventions in the financial sector are specifically aimed at broadening access. ICICI bank started targeting the market of the poor because of priority sector requirements. Such requirements, even when distortive, may compensate for other pressures.

Fourth, gradual liberalization may be preferable, accompanied by an explicit process of increased accountability and public scrutiny during the process. Given the complexity of financial reform, oversight needs to be targeted at limiting abuse of power by legislators, enforcing agencies, or lobbyists on the part of powerful interests. Perotti and Volpin (2007) show that newspaper circulation has a highly robust link to reliable access to finance, probably because it proxies for the degree of public scrutiny upon policy choices. Better public scrutiny should also make reforms more sustainable. On this account, a most important criteria for assess to assess any process of financial reform should be whether it achieves the goal of promoting entry and broadens access to finance.

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