DEMOCRATIZATION AND FINANCE: THE POLITICS OF FINANCIAL DEREGULATION IN SPAIN

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Introduction*

Many countries have sought to liberalize their financial markets in recent years.[1] Among these countries have been some with "restricted" or "repressed" financial systems, the most common type of financial system since World War II, especially in the Third World.[2] In a restricted system, the government imposes credit, entry and interest rate controls and impedes the development of bond and equity markets in order to make key pricing and allocation decisions; it taxes the banking system to obtain state revenue; and it strictly controls capital inflows and outflows to regulate and limit interaction between domestic and international capital markets.[3] Starting in the 1960s, many economists have urged countries with restricted systems to liberalize their financial markets, asserting that restriction lowers efficiency and, therefore, reduces growth.[4] Some of these countries deregulated their financial markets soon after, but many did not until much later and some have not done so at all.

Spain is one country that has undergone significant financial deregulation. Policy makers began liberalizing the country's restricted system around 1970, with the most important reform occurring in the late 1970s and early to mid-1980s. The Spanish experience is intriguing because it

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[1] These countries include Australia, Chile, France, Japan, Mexico, South Korea, Spain, Turkey, Britain, and the United States. Scholars attach different meanings to the terms "deregulation" and "liberalization." Most broadly, these terms denote the removal of capital, credit, entry, and interest rate controls, the development of efficient bond and equity markets, and the elimination of taxation of the financial sector. For example, see Fry (1988), McKinnon (1973; 1991), and World Bank (1989).

[2] Many countries have had a restricted or "repressed" system at one point in time. The list includes Brazil, India, Japan, Mexico, the Philippines, Spain, and Turkey.

[3] See Fry (1988) and McKinnon (1973; 1991) for detailed discussions of the characteristics of restricted financial systems.

[4] A classic critique of financial repression is McKinnon (1973).

presents several challenges to prevailing explanations of financial deregulation and structural adjustment more broadly. First, Spanish liberalization occurred before the international factors (for example, increasing capital mobility) that some scholars claim explain recent deregulation efforts became significant.[5] Second, against the predictions of sectoral models of economic policy making, deregulation took place despite strong opposition from powerful, well-organized private interests, like large national banks.[6] Finally, most financial reforms occurred while Spain was democratizing, a time when many authors suggest governments either avoid or find it difficult to implement structural economic reforms.[7]

This paper examines the political economy of Spanish financial deregulation efforts.[8] Its most striking finding is that democratization encouraged Spanish political leaders to deregulate financial markets in order to improve economic performance and win broad-based support. Spain's new democratic institutions led officials to place less emphasis on supplying private goods (for example, preferential credit) through the use of financial controls than on supplying the collective good of a more market-based, efficient financial system in their pursuit of power. The electoral rules chosen during the democratic transition played a particularly important part in shaping the incentives facing politicians as they designed financial policy; a different set of rules might have encouraged continued heavy state intervention in financial markets. In this interpretation, financial market reform was a consequence of the decision to adopt a particular form of democratic rule. This view challenges the prevailing belief that Spain's entry into the EC

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[5] For example, see Andrews (1994) and Goodman and Pauly (1993).

[6] An example of a sectoral political economy model is Frieden (1991). Sectoral models of financial policy include Hammond and Knott (1988) and Rosenbluth (1989).

[7] See Institute of Latin American Studies (1986), Smith (1989), and Stallings and Kaufman (1989) for examples of this argument. The empirical evidence on this point is mixed. See Lindenberg and Devarajan (1993) and Remmer (1990). The first post-Franco elections were held in 1977.

[8] Excellent general studies of contemporary Spanish political economy in English are Bermeo and García Durán (1994), Dehesa (1994), Maravall (1993), and Pérez Díaz (1987).

was the primary cause behind the country's structural reforms, including financial deregulation.[9] The impact of EC requirements on Spanish economic policy varied greatly across sectors; it did not require a major transformation of financial policy. Moreover, the decision to enter the EC was itself endogenous, and was motivated in part by the same variable that I argue explains structural reform: a desire to improve economic performance to increase political support.

I suggest more broadly that democratization[10] may often provide politicians with an incentive to liberalize financial markets. Democratization pushes elected officials to provide for the collective economic good because they must competitively bid for the support of a heterogeneous majority in periodic elections. With regards to financial policy, it encourages leaders to create efficient markets through deregulation and dismantle inefficient financial controls used to favor particular constituents. In addition, as democratization usually increases the number of groups making claims on policy makers, politicians may dismantle interest rate and credit controls out of fear that they cannot satisfy all the demands for preferential credit and will alienate some constituents. Finally, democratization is often associated with a dramatic surge in demands for government spending. This provides a powerful incentive to eliminate inefficient taxation of the banking system and implement more effective means of taxation. Of course, democracies differ greatly, and not all transitions to democracy will lead politicians to liberalize financial systems. In this paper I briefly analyze how differences in electoral systems affect the incentives facing politicians as they formulate financial policy.

More generally, this paper provides an analytical framework that identifies the conditions under which deregulation is likely to occur using a rational choice approach. I argue that public officials provide the dynamic behind the evolution of financial policy. They design financial regulation with two goals in mind: retaining power and generating government revenue.

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[9] For example, see Bermeo and García Durán (1994).

[10] For example, see Bermeo and García Durán (1994).

Politicians will deregulate financial markets when the utility of a restricted system in helping them to ensure their own political survival and raise government revenue decreases relative to that of a market-based system.

This study bears on three central issues in the theoretical literature on economic policy making. First, this paper seeks to further the debate over whether the central dynamic of economic policy making is found at the international or domestic level by looking at financial policy choice.[11] It suggests that while international factors impose important constraints on leaders, domestic politics still largely shape the evolution of financial policy. Second, this essay addresses the issue of when state- or society-centered analysis is most appropriate in understanding financial policy making.[12] It concludes that market structure - specifically the degree of competition - influences whether public or private actors provide the impetus behind financial deregulation and, therefore, whether state or society should be the center of analysis. Finally, this paper contributes to the literature on how domestic political institutions shape the incentives facing public officials as they design regulatory policy.[13] In particular, it seeks to broaden our understanding of how democratization affects the prospects for structural reform. I conclude that this study's rational choice approach is able to capture differences in the reward structures presented by authoritarian and democratic regimes and demonstrate how these differences affect economic policy making. However, it cannot explain inter-governmental differences in behavior of politicians facing similar institutional constraints after democratization; these variations must be explained by an entirely different set of factors. Rational choice approaches that explain political behavior solely by specifying the institutional reward structure confronting politicians are inherently incomplete; they must be supplemented by attention to variables at other levels of the political system and the interactions among them.

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[11] There is a large literature on this debate. Important recent works include Ikenberry, Lake, and Mastanduno (1988), Kahler (1992), and Stallings (1992).

[12] The literature on state- and society-centered approaches is vast. For examples of the former, see Skocpol (1985) and Zysman (1983). For examples of the latter, see Frieden (1991), Gourevitch (1986), and Milner (1988).

[13] I use Hall's (1986, 19) definition of institutions as "formal rules, compliance procedures, and standard operating procedures that structure the relationship between individuals in various units of the polity and economy."

The Analytical Framework

In this section, I advance the argument that politicians deregulate financial markets when the political utility they derive from a restricted system decreases relative to that of a more market-based system. I take as a basic premise that public officiall[14] may intervene in markets independent of the demands of social groups for regulation; they possess distinctive interests and may attempt to use the instruments of the state to shape markets to further their goals. Therefore, to understand economic policy one must consider the political problems that politicians attempt to solve when they intervene in markets.[15] That is, it is necessary to look at the factors that influence the supply of regulation as well as those that shape the demand for it.

I assume here that public officials attempt to solve two fundamental, interrelated political problems. The first is to ensure their own political survival.[16] Holding power is a prerequisite for most objectives that an official may seek. The second is the need to raise government revenue.[17] As Levi (1988, 3) contends, government revenue facilitates the attainment of a public official's goals,

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[14] In constructing my analytical framework, I initially argue at a high level of abstraction, concentrating on political leaders and their goals. Moreover, I assume that these officials have homogeneous preferences and that principal-agent problems are limited. In the case study of Spain, I distinguish between the preferences of various types of public officials. To minimize repetition, I sometimes use the term "politicians" in place of political leaders.

[15] Bates (1988) has argued for this approach.

[16] This is the central assumption of the so-called "economic approach to politics." Among those who posit this are Becker (1983), Peltzman (1976), and Stigler (1971).

[17] See Levi (1988) on the argument that generating government revenue is a central goal of public officials. Unlike Levi, I do not contend that public officials necessarily seek to maximize revenue; rather, I argue that, at a minimum, they attempt to generate enough revenue to provide essential services, leaving open the possibility that they may try to raise more. A variety of factors, including a country's political institutions, influence whether they appropriate revenues for themselves or spend them responsibly. While holding power and raising revenue are usually complementary goals, politicians sometimes must make trade offs between them. For instance, politicians may hurt their prospects for political survival if they tax constituents excessively, but they may lose out to rivals if they cannot obtain sufficient revenue to provide essential services. As my purpose here is to illustrate the utility of an approach based on the premise that politicians shape regulatory policy to advance their own goals - whatever their exact nature in specific cases - I assume that politicians strive to achieve both goals, devising trade-offs between them as circumstances require.

whether they be personal or social. Moreover, leaders will not remain in power if they cannot raise enough revenue to provide the services that constituents demand.

Financial restriction may be very useful to politicians seeking to achieve both goals.[18] First, interest rate and credit controls allow politicians to win or retain political support by directing available credit at subsidized rates to actual or potential supporters. If a country's political institutions reward those that deliver benefits to key private groups, politicians will especially value restriction. Second, taxation of the banking system provides a source of government revenue. Heavy reserve requirements allow fiscal authorities to tap savings mobilized by the banking system at zero- or low-interest cost; asset restrictions enable them to reduce the cost of financing state activities and ensure the placement of government bond issues.[19] Politicians resort to taxation of the banking system despite its high efficiency costs because a more orthodox and efficient means of public finance is often politically infeasible.[20]

Although restriction provides politicians with a means of delivering financial benefits and raising revenue, it generally leads to financial inefficiency.[21] Market-based financial systems promise greater efficiency, but are seemingly more difficult to manipulate for political purposes because they do not give public officials the means to affect directly the fortunes of particular groups. A more

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[18] See Lukauskas (1994) for a more complete discussion of the points that follow.

[19] Asset restrictions require financial intermediaries (for example, banks) to hold public debt at yields below market rates. In a study of 24 countries, Giovannini and Melo (1993) found that governments used asset restrictions to generate cost savings equivalent to an average of 1.8% of GDP and 8.7% of central government revenue.

[20] Reserve requirements and asset restrictions substantially increase financial margins and introduce rigidity in the operations of intermediaries, thereby sharply reducing financial efficiency. Consequently, in the absence of political constraints, a policy maker seeking to maximize the present discounted value of the future stream of government revenues would not choose restriction since it hinders the long-term economic growth that ultimately increases revenues. See Giovannini and Melo (1993).

[21] Most economists believe that restriction leads to financial inefficiency. The empirical record, however, is inconclusive because of (1) the difficulty of measuring financial efficiency and its impact on economic growth; and (2) the apparent success of restriction in several East Asian countries. See Lukauskas (1997) on these points. For the purposes of this paper, I assume that market-based systems provide performance superior to that of restricted systems, as this view prevails among economists. For example, see Fry (1988), McKinnon (1991), and World Bank (1989)

market-based system is politically valuable, however, when a country's political institutions provide politicians with an incentive to supply collective economic goods, such as efficient financial markets, instead of private goods, such as subsidized credit, in the pursuit of power. Such a system is also valuable because it improves the stream of government revenues by promoting long-term growth. In conclusion, restricted and market-based financial systems have distinct political merits whose value to politicians varies across different institutional settings.

This analysis implies that changes in a country's political institutions may provide leaders with an incentive to alter the financial regulatory regime. Specifically, politicians may liberalize markets when changes increase the political utility of a more market-based system relative to that of a restricted system. The utility of a market-based system rises when: one, the value of supplying more efficient market arrangements increases relative to that of providing private financial benefits to select constituents in the pursuit of power; two, more efficient means of taxation become available and politically feasible. Leaders will likewise deregulate when the costs of maintaining restriction come to exceed its benefits, turning a restricted system into a political liability. This may happen when restriction so lowers financial efficiency that it impedes growth, providing rivals with an issue that they can use to challenge current leaders. A sharp rise in financial inefficiency may partly explain the apparent but uneven recent general trend toward macroeconomic orthodoxy and financial reform. However, even where events have led to similar economic problems or constraints across countries, they have not affected the political calculus of leaders equally, indicating that economic factors alone cannot explain economic policy change.

Events that create an incentive to deregulate may not actually produce liberalization. Politicians must have sufficient autonomy to implement reforms in the face of probable opposition from a variety of social and state actors that benefit from the status quo. In addition, politicians must be able to overcome the collective action problems that they themselves face when seeking to set up more efficient market structures and have a sufficiently long time horizon (as the benefits from deregulation are usually not immediate).

Applying this framework to Spain, I identify two factors that were critical in producing financial deregulation. First, a surge in political dissent fueled partly by dissatisfaction with economic policy led the Franco regime to liberalize markets partially starting in the late 1960s; officials hoped a change to a more market-based system would help sustain strong growth, improving the country's standard of living and defusing political opposition to the regime. Second, Spain's transition to democracy in the late 1970s led government officials to reopen the process of financial liberalization after it had stalled several years earlier. The country's new political institutions encouraged national parties to appeal to encompassing interests in order to construct a broad-based, heterogenous constituency; pursuing a strategy based on targeting narrow groups was not a viable strategy for obtaining sufficient electoral support. In the realm of financial policy, this meant politicians placed more emphasis on creating efficient financial markets via liberalization, and less on providing private benefits, like preferential credit, to key constituents. In addition, greatly increased demands on state expenditures brought on by democratization eventually pushed them to seek more efficient means of raising revenue, namely direct taxes and a value-added tax.

Democratization and Financial Liberalization

The finding from Spain that democratization provided an impetus for financial liberalization is intriguing, since it is often argued that governments in new democracies find it particularly difficult to implement structural economic reforms. There are, however, several reasons why democratization might encourage political leaders to liberalize financial markets, at least in the long run. I contend here that democratization often reduces the utility of financial restriction in helping politicians to achieve their goals of holding power and generating sufficient government revenue.

Many countries begin the process of democratization with non-competitive political systems where political institutions provide national leaders with a relatively greater incentive to supply private instead of collective goods in their quest to retain power. In these systems, the ability of rulers to deliver private benefits (like preferential credit) to key social groups is most critical for maintaining power, as their hold on office often rests on the backing of narrow groups of powerful constituents. Supplying collective economic goods for the general populace is less important - unless economic performance deteriorates so much that internal or external rivals are able to challenge the regime - since rulers often need only the acquiescence of a national majority, not its active support. This suggests that creating a restricted financial market to devise a means of delivering private benefits has an especially high payoff in political systems in which there is an absence of political competition.[22]

In democratic regimes with a competitive party system, on the other hand, institutions give public officials a relatively greater incentive to supply collective goods like efficient markets, even though delivering private goods to important constituents may retain considerable value.[23] In general, national parties in a competitive democracy must appeal to voters by advocating policies that provide for the collective economic good, since they are bidding for the support of a heterogeneous majority in periodic elections. A party that appeals only to narrow groups or designs policies for their benefit once in power may be seen as hostage to their interests and, thereby, alienate median voters, making it difficult for it to secure adequate electoral backing. In addition, policies designed to benefit only select groups are less likely to proliferate in democracies than in autocracies because constituents

[22] Bates (1983) reaches a similar analytical conclusion in his study of when politicians have the greatest incentive to design agricultural policy so as to be able to supply private benefits.

[23] Downs (1957) argued that when political power is highly dispersed, as in a democracy with universal suffrage and accountable administrative functions, diffuse interests have a stronger voice in public policy. Drawing on the work of Downs, Aronson and Ordeshook (1985) contended that a two-party democracy produces an optimal level of public goods. In a similar vein, Becker (1983), Stigler (1982), and Wittman (1989) also claimed that the greater political competition of democracy brings about more efficient policy choices. The primary difference between authoritarian and democratic regimes is that the latter grant opposition groups the right to contest incumbent rulers, and replace them through competitive elections.

have the ability to oust rulers that mismanage the economy.[24] Therefore, movement toward a competitive democratic regime may result in a larger supply of collective economic goods; in the realm of financial policy, this may spark efforts to increase the efficiency of financial markets through liberalization.

The advent of democracy also leads to a reshaping of the political landscape, as individuals previously excluded from political activity are able to gain a voice in public life through the ballot box, and sometimes, identify common interests and organize for political action. In the short-term, politicians concerned with their immediate survival may have to turn to established groups for support, since new political actors may not be organized into effective interest groups. In the longer run, however, they will have to consider the interests of newly empowered groups if they want to succeed electorally. In the case of financial policy, these groups will probably make demands that require some liberalization. The middle class, for example, will want deeper and more efficient mortgage markets to finance the purchase of homes. It will also desire new financial instruments and deeper bond and equity markets to facilitate long-term saving for other goals, such as education and retirement, and to diversify their assets away from only short-term, highly liquid instruments. These groups are unlikely to organize to lobby on financial policy issues because of collective action problems, so the most likely way their demands will find their way into the political system is through political entrepreneurs.

Changes in interest group demands are important in another way as well. In a non-democratic society, the use of credit and interest rate controls to generate support is cost effective because providing benefits to a few key social groups is often sufficient. After democratization, it is usually no longer an efficient means of mobilizing support, since political leaders have to respond to pressure for credit rents from a much larger set of interest groups and confront the issue of what is a "fair" distribution of preferential credit. If they do not provide credit rents to all who demand them, excluded groups may turn hostile to the democratic process; if they do, they will place impossible

[24] Lake (1992) and Maravall (1994) are among the scholars that make this argument.

demands on state resources and further distort the functioning of financial markets. Under these circumstances, political leaders have an interest in eliminating selective credit policies, thereby closing a channel of disruptive and insatiable social demands. Abolishing credit programs has the additional advantage of reducing the revenue needs of the government.

Democratization also reduces the utility of restriction in helping public officials to achieve their second goal, obtaining sufficient government revenue. Transitions are often associated with a dramatic surge in demands for social welfare services and income redistribution that translate into a need for more revenue. These demands are unlikely to be met by raising indirect taxes, like taxation of the financial sector. Governments may initially try to deepen restriction to extract incremental revenue, but at a certain point their efforts become self-defeating. Intermediaries will undertake innovation to circumvent financial controls that act as a tax, and this will limit the amount of additional revenue that the state can generate through taxation of the banking system. More fundamentally, excessive taxation generates inefficiencies that slow growth and, hence, limit the expansion of the tax base; this will ultimately reduce the flow of government revenue. Unless a more effective means of raising revenue is put in place, the state may face a fiscal crisis that ultimately challenges its legitimacy. This provides a long-term incentive to dismantle restriction and implement more effective means of taxation (for example, a greater reliance on direct taxes).

Democratization may also facilitate the implementation of a system of direct taxation (where it was previously not possible for political reasons) because it is often accompanied by a change in notions of legitimacy and demands for greater social justice. Specifically, it may generate pressure for a more equitable distribution of the tax burden, through the adoption of progressive direct taxes, by those disadvantaged by indirect taxes. Leaders who wish to reshape fiscal policy can take advantage of this pressure to secure support for tax reform.

The Temporal Pattern of the Reforms

The prospects for financial liberalization are likely to change over time. Przeworski (1991, ch.4) shows that because many structural reforms entail high short-term costs and produce benefits only in the long-term, they are difficult to sustain once started, since leaders must cope with rising discontent among the populace and political competitors who try to capitalize on it. Transitional democracies may face special problems in undertaking reforms because their leaders feel pressure to provide immediate material benefits to an impatient population, and they have insecure tenure in office; this can lead them to adopt a short time horizon. Moreover, the institutional structure needed for formulating and carrying out reforms may be lacking. Therefore, in the case of financial policy, one might expect the transition to lead to some financial reform immediately (especially if economic conditions are deteriorating) and a period of retrenchment as the short-term costs of reform are felt fully. Later, there might be a renewal of the liberalization process as the benefits from earlier reforms become clear or the costs of not deepening the reform process rise, and as governments develop the autonomy and institutional structures needed to implement reforms successfully.

Joan Nelson (1993, 447) finds empirical support for this pattern. She notes that first or second post-transition governments have found it difficult to sustain tough structural reforms. Mounting economic difficulties coupled with broadened recognition that partial measures were not effective, however, later led to reform in some countries.

Differences across Democracies

The incentive of parties and the politicians within them to appeal to encompassing interests and supply collective goods once in office varies greatly across democracies. Indeed, some democracies reward parties or politicians who develop close ties to select constituencies. In these systems, one would expect politicians to have a greater interest in financial restriction. Japan, for example, had a financial system that exhibited many elements of restriction until very recently. Calder (1993) demonstrates that Japanese financial policy reflected the distributive, clientilistic nature of Japanese democratic politics. Japan's electoral system and political culture are biased toward securing power through the cultivation of small, intense support groups with material benefits (Calder 1988a). Japanese politicians aggressively used financial controls to distribute preferential credit to key constituents, such as small businesses in the provinces.

The extensive literature on democracy offers no firm maxims about which types of systems encourage leaders to supply collective as opposed to private goods, or which tend to be more stable over time, thereby allowing politicians to carry out reformist agendas.[25] Although scholars have identified certain broad traits with particular types of democratic systems, countries with similar formal institutions often exhibit considerable differences in how they function. This is due to variations in micro level institutional variables as well as basic differences in political culture and history, population, and social institutions. Here I limit myself to offering some observations on which sorts of democratic systems are more or less likely to give national leaders an incentive and capacity to supply collective goods, concentrating on electoral systems and constitutional frameworks. This is meant to be an intuitive, not exhaustive exercise.

It must be noted that an analysis of political institutions cannot provide the determinants of political behavior. Identical electoral institutions, for example, may yield different political results depending upon the characteristics of political elites and the populace. Moreover, institutions, like electoral rules, themselves must ultimately be treated as endogenous variables. Fundamental political variables, such as the distribution of power among social groups or historical experience, greatly influence the choice of a country's institutions. A systematic analysis of this issue is beyond the scope of this study, but I offer some observations on the Spanish case.

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[25] Among the important attempts to get at these issues are Bates (1983), Geddes (1994), Haggard and Kaufman (1995), and Haggard and Webb (1994).

The features of a country's electoral and party systems critically affect the incentive to appeal to encompassing interests and ability to supply collective goods. Electoral systems vary greatly in the reward structure that they present to politicians and in their capacity to create legislative majorities capable of introducing credible policy initiatives. Scholars identify three variables as most important in shaping the political effects of electoral systems: electoral formula, such as plurality or the different types of proportional representation (PR); district magnitude (that is, the number of representatives elected per district); and electoral threshold (that is, the minimum support a party needs to gain representation).[26] These factors have a direct impact on the degree of multipartism and fragmentation as well as on the proportionality of electoral outcomes, including the tendency to generate majority victories.

Whether parties function on the basis of "open" or "closed" list systems is also significant, as this influences how much control party leaders exercise over individual party members.[27] In open list systems, party leaders do not determine who appears on the ballot or the order in which candidates are listed. Thus, they lack an important means of controlling candidates who wish to follow a private agenda. In closed list systems, party leaders make up electoral lists and, hence, can control individual party members. Therefore, party systems that use closed and blocked lists should generally lead to greater party unity and less parochialism.

Another institutional feature that seems to have a bearing on the incentive and ability to supply collective goods is a country's constitutional framework, that is, whether a democracy has a presidential or parliamentary system. Much recent literature claims that parliamentarianism is more favorable for building stable democracies capable of promoting the public good than presidentialism.[28] In principle, a presidential system might encourage the provision of collective goods because

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[26] Lijphart (1994, 1). A full discussion of these variables is found in Ibid., chap. 2. See also Taagepera and Shugart (1989).

[27] Geddes (1994) and Mainwaring (1991) discuss the importance of closed and open party lists.

[28] See Linz and Valenzuela (1994) and Mainwaring (1993). Shugart and Carey (1992) dispute this view.

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presidents must attract a heterogenous, national constituency. The appeal of a strong, energetic executive focused on the public interest is in fact why some countries opt for a presidential system. Many scholars, however, suggest that presidentialism suffers serious deficiencies compared to parliamentarianism in practice. Stepan and Skach (1993, 16-22), for example, argue that presidential systems possess: a lower propensity for governments to have majorities to implement their programs; a lesser ability to rule in a multiparty setting; a greater proclivity for executives to rule at the edge of the constitution; and a lesser tendency to provide long party/government careers, which add loyalty and experience to political society. Mainwaring (1993) claims that the combination of presidentialism and multipartism, common in new presidential democracies, is especially inimical to the creation of a stable political system.

The significance of the above institutional features can be illustrated by creating ideal types of democratic systems that seem the least and most conducive to the supply of collective goods. Democracies with highly fragmented party systems, especially presidential regimes, where parties operate with open lists are probably the least conducive to supply of collective economic goods. Politicians in such systems are able to pursue private agendas, and have an incentive to appeal to local or other parochial interests in their pursuit of office. This is especially true if the bases of electoral support are geographically concentrated (as is the case in countries divided along cultural or ethnic lines), or if national politics are highly polarized along ideological lines. In these circumstances, a politician's prospects hinge upon her ability to deliver benefits to her home region or maintain a clear ideological stance. In addition, legislative majorities are more difficult to achieve in highly fragmented systems. If a transition results in this type of democracy, politicians will value financial restriction for its ability to target specific groups, and liberalization will be unlikely in the short run. Brazil is an example of a democratic system with a presidential regime that has provided few collective action incentives for reform because it encourages politicians (with some exceptions) to target narrow local or regional interests.[29]

[29] See Mainwaring (1991) on Brazil's electoral system and its impact on the strategies of politicians. See Armijo (1993) on Brazilian financial policy.

Democratic systems exhibiting a low degree of party fragmentation or polarization, where parties operate with closed lists, are probably most amenable to the supply of collective economic goods. Generally, one would expect that the closer a democratic regime gets to a two-party system based on heterogeneous catch-all parties, the more likely it is to produce an optimal level of public goods for the reasons already identified. Contemporary Spain, as I discuss below, is an example of a country with such a system. Its electoral laws penalize small, sectarian parties with geographically dispersed support and encourage the emergence of large, broad-based national parties. Spanish parties must appeal to encompassing interests to gain adequate electoral support and have an incentive to supply collective goods once in office to retain power.

Financial Liberalization in Spain

The Spanish financial system has undergone a dramatic transformation in the last thirty years, moving from a repressed to a largely market-based system. I begin my discussion of Spanish financial policy by briefly examining the political economy of its period of financial restriction. This provides the economic and political context for the discussion of deregulation in Spain. Moreover, understanding what motivated Spain's political class to seek restriction is important to explaining why it later chose to liberalize financial markets.

Financial Restriction in Spain

The Franco regime pursued a strategy of financial restriction upon taking power in 1940. The peak of state intervention in the financial system came in the mid-1960s, when the government sought to control most key dimensions of financial activity. Several characteristics of the Spanish financial system in this period were noteworthy.[30] First, the Ministry of Finance [MOF] imposed controls on both deposit and loan interest rates. Second, most credit to the private sector flowed through a cartelized banking system (made up of banks and savings banks) and not direct financial markets. In the 1960s and 1970s, direct financial markets supplied only about six percent of credit to the private sector. Moreover, the degree of self-financing among firms was the lowest of any industrialized country.[31] Third, the percentage of government-allocated credit was high, typically about thirty-five percent of all credit to the private sector. Authorities used a variety of selective credit policies to force private lenders to channel available credit to favored sectors at preferential rates. Fourth, the banking system was the object of considerable taxation. Intermediaries had to invest in low-yield government securities and provide credit at preferential rates to favored sectors; in the 1970s, they were also subject to heavy reserve requirements. Fifth, the Spanish financial market was closed off from international capital markets.

In the 1960s, officials in the Franco regime used financial policy to establish a means of obtaining government revenue and distributing private financial benefits. They created several mechanisms for extracting seignorage from the banking sector, notably asset restrictions. This policy was necessary because the Franco regime chose not to implement more efficient means of taxation, such as direct taxes (for example, income taxes), out of fear of alienating important constituents among the middle and upper classes. Officials implemented interest rate and credit controls that enabled them to allocate large amounts of credit according to their own politically-based criteria; eventually, they even devised a means of shifting the cost of operating selective credit policies onto the banking system. The regime's leadership encouraged the disbursement of private financial benefits because it believed it would coopt key industrial interests and create goodwill toward the regime.

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[30] For further elaboration on the analysis in this section, see Lukauskas (1997).

[31] In 1964-65, the percentage of self-finance in total industrial financing in Spain was only 27%. In contrast, it was 54% in the United States, 49% in West Germany, and 42% in England (in 1968-70). Lieberman (1982, 241).

The primary private sector beneficiaries of restriction in Spain were banks and firms targeted by interest rate controls. Entry and interest rate controls limited competition and reduced risk, allowing banks to earn high, risk-free profits. In addition, policies to suppress direct markets meant that banks were practically the sole providers of finance for industry. Although some aspects of the financial regulatory regime imposed costs upon them (for example, asset restrictions), banks were firm supporters of it since they benefitted so much from their dominant position in the financial sector and sure profits. Firms targeted by credit and interest rate controls obtained guaranteed access to loans at cheap rates, even when credit got tight. The biggest losers of restriction were savers and firms rationed out of credit markets. They did not lobby policy makers on financial policy issues, however, because of collective action problems. The benefit accruing to any individual firm or saver from a change in financial policy would have been relatively small and had the nature of a public good; this encouraged free riding.

Quantitative estimates of the social welfare cost of restriction in Spain are not readily available due to the difficult measurement problems and counterfactuals involved. Most economists, in both Spain and international agencies like the Organization for Economic Cooperation and Development (OECD), believe that they were large.[32] Among the many problems they cite are: high financial margins; inefficient allocation of available credit; a disincentive to save and, hence, insufficient mobilization of financial resources; and serious monetary control problems.

The strength of the private and public actors who benefited from restriction and the inertia of potential opposition seemed to make a movement for liberalization unlikely in Spain. Yet, starting in the late 1960s, government officials began liberalizing markets by removing some interest rate controls and increasing competition among intermediaries. After 1977, they intensified the deregulation process by dismantling credit controls and increasing links with international capital markets while also deepening on-going reforms. In the following sections, I examine why

[32] For example, see Banco de España (1971), OECD (1966; 1969, 1987), Lieberman (1982), and Trias Fargas (1970). One quantitative estimate of the cost of the remaining features of restriction in the 1980s is cited below.

deregulation occurred in Spain, beginning with my general argument. I also contrast my view with alternative explanations derived from competing theoretical frameworks. Finally, I discuss the Spanish reform process in detail.

Competing Explanations of Financial Deregulation

I argue that deregulation occurred in Spain when political leaders determined that it was politically advantageous to seek the greater efficiency that a market-based financial system promised. The specific concerns that created interest in better economic performance varied across time, but they all centered on the goal of generating political support. During the Franco era, a swell in political dissent in the late 1960s sparked interest in financial reform among regime leaders. They decided to permit the MOF to pursue limited structural reforms aimed at increasing economic efficiency and growth as well as lowering inflation. They hoped that rising standards of living and stable prices would reduce hostility toward the regime and eliminate a potential basis of support for opposition groups. Later, Spain's transition to democracy ushered in a competitive political environment that pushed national leaders to improve economic performance in order to secure broad-based electoral support; in the realm of financial policy, this encouraged them to liberalize financial markets. Of course, other variables - notably economic conditions and Spain's entry into the EC - have also had a major impact on the evolution of financial regulation; I discuss these factors below.

I contend that Spanish financial policy should not be conceptualized as the product of closely guarded, ongoing negotiations between bureaucrats and regulated banks, a view that sometimes appears in studies of financial regulation.[33] Leaders, in response to the constraints and opportunities generated by their political environment, establish the general policy framework in which technocrats must operate. True, they often delegate rule-making authority to bureaucrats, who may then design

[33] See especially Pérez (1997).

regulations within the established guidelines in consultation with banks, but politicians ultimately retain control over the regulatory regime.[34] Technocrats, for instance, will not eliminate credit controls if their political superiors favor state control over credit allocation. Even in Japan, where the autonomy of bureaucrats in financial policy has always been considered especially great, Rosenbluth (1989, 132) notes: "What deceptively appears to be bureaucratic-led policy making . . . is high politics in disguise, little different in substance from instances of direct political involvement."[35]

In Spain, political control was great because authority over financial policy was concentrated in the post of the Minister of Finance,[36] who served at the pleasure of the Prime Minister, or during the Franquist regime, the Franco inner circle. The extent of political control is evident in that changes at this post, which themselves were reflections of changes in the political calculations of the Franco inner circle, the UCD or PSOE, led to important modifications in financial policy. In particular, major policy shifts occurred with the entrance and exit of Barrera (1973, 1974); Fuentes Quintana (1977, 1978); Abril Martorell (1978, 1980); and García Díez (1980, 1982); some of these episodes are discussed below.

My view of Spanish deregulation efforts contrasts with explanations derived from the principal theoretical approaches used to explain the evolution of financial policy in the existing literature. I discuss three such approaches here, outlining their general characteristics and considering their application to Spain.

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[34] The view that bureaucrats can dominate regulatory policy free of political control has been sharply criticized in recent years. For two important works in this vein, see Derthick and Quirk (1985) and Wilson (1980).

[35] See also Calder (1993), p. 66.

[36] Administrative reorganizations moved control over financial policy to the Ministry of Economics (1977-1982), and later to the Ministry of Economics and Finance (1982-).

The "Economic Theory"

The most prominent approach to explaining financial liberalization in the literature is based on the "economic" theory of regulatory policy.[37] In this view, deregulation occurs when a regulatory regime becomes suboptimal for its beneficiaries, or the net balance of interest-group demands on public officials shifts because of changes in the bargaining power of its winners and losers. The theory also raises the possibility that public officials will initiate deregulation if the existing regulatory regime begins to generate large deadweight economic losses, since consumer and producer surplus are also sources of political support.[38] To my knowledge, this argument has not been made with respect to financial policy.

Using the economic theory, scholars have explained deregulation by arguing that regulated financial intermediaries (notably, banks) have provided the impetus for deregulation when economic changes, like high inflation, have made the existing regulatory regime unprofitable for them. Specifically, they suggest that deregulation has often originated in the efforts of regulated banks to eliminate deposit rate ceilings. In general, banks favor these ceilings because they limit competition for deposits and raise profits. They will seek the removal of ceilings, however, when they limit their ability to compete for deposits with new, unregulated intermediaries, or when they face the threat of disintermediation[39] from direct financial markets. The U.S. experience with deregulation illustrates this point well. In the 1970s, U.S. banks were unable to compete with nonbank intermediaries offering liabilities, such as money market mutual funds, that were not subject to deposit rate ceilings

[37] The economic theory argues that public officials design regulation to favor groups that offer them the greatest political support. Becker (1983); Peltzman (1976; 1989); and Stigler (1971) have developed the economic theory. Applications of the theory to financial policy include Hamada and Horiuchi (1987), Hammond and Knott (1988), and Rosenbluth (1989).

[38] See Becker (1983) and Keeler (1984).

[39] Disintermediation occurs when savers lend funds directly to the final users of credit, thereby eliminating the intermediary services performed by banks.

as inflation accelerated. As a result, they lobbied authorities and obtained the removal of interest rate controls in 1980.

Interest rate deregulation is significant because it typically sparks more extensive financial deregulation. In the United States, interest rate liberalization exposed unequal playing fields in areas of non-price competition. Intermediaries left at a competitive disadvantage then lobbied to reform regulations in these areas. As policy makers altered regulatory policy in response, other regulations became controversial, and authorities came under fire to modify them as well. In conclusion, partial deregulation created a "deregulatory snowball" that eventually led to calls for a thorough deregulation of the financial sector.[40]

The economic theory cannot account for financial deregulation in Spain. The impetus for deregulation came from public officials, not from a change in the preferences of restriction's private sector beneficiaries or the net balance of interest-group demands on policy makers. Private groups active in financial policy strongly opposed deregulation. In contrast to the experience of countries with highly developed financial markets, regulated banks aggressively lobbied against most reforms; only in the late 1980s did banks accept (though not embrace) deregulation. The economic events (for example, high inflation) that have led regulated intermediaries to push for deregulation in other countries did not alter the costs and benefits of existing regulations sufficiently for Spanish banks to prefer deregulation. Specifically, as there were few non-regulated intermediaries to challenge banks and the threat of disintermediation from direct markets was weak, banks did not have an incentive to seek the removal of controls that still provided ample benefits. On the other hand, groups that stood to benefit from deregulation - savers and firms rationed out of credit markets - did not press for it, due to collective action problems. Although some large firms favored greater freedom to tap global capital markets, there is little evidence that they lobbied the government on this matter or that they favored other changes in financial deregulation.

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[40] See Hammond and Knott (1988).

A general analytical proposition might be drawn from the Spanish experience with deregulation and how it differed from that of countries with more highly developed financial systems. Financial market structure, notably the degree of competition, influences whether public or private actors push for deregulation and, therefore, whether state or society should be the center of analysis. In countries with restricted systems, regulated intermediaries have little incentive to seek changes in a status quo which provides essentially risk-free profits; therefore, public actors will have to provide the impetus for deregulation. In countries with deep financial markets, private actors are most likely to provide the push for deregulation in response to changes in the economic environment. This proposition is consistent with the growing consensus that a variety of institutional factors help determine the relative importance of state and social actors in influencing economic policy.[41] It highlights the necessity of examining the variables that affect the supply of regulation by public officials as well as the demand for it by private actors.

The Public Interest View

Another influential approach, labeled the "public interest" theory, contends that financial liberalization has stemmed from policy makers' efforts to promote aggregate social welfare.[42] This theory holds that officials deregulate restricted systems when they become aware of the costs associated with excessive government intervention. Specifically, they liberalize when they confront low financial efficiency, a lack of monetary control, or declining flows of foreign funds, and decide that they can best overcome these problems by abandoning a strategy of restriction. In this perspective, the serious economic difficulties that many countries have faced in the last two decades have sparked the recent wave of financial reform. Some authors have extended this argument by suggesting that the World Bank and International Monetary Fund (IMF) greatly aided deregulatory

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[41] For example, see Gowa (1988).

[42] Cole and Wellons (1989), Harper (1986), and Loriaux (1991) are examples.

efforts by diffusing a set of ideas that posits that countries can improve their economic performance through financial liberalization.[43]

Applying this framework to Spain, the claim is that public-spirited government officials reformed financial policy as its deficiencies became apparent. In particular, monetary control problems, contributing to high inflation, and mounting financial inefficiency, leading to slower growth, led officials to remove cumbersome and harmful financial controls.

Analytically, the differences between my explanation and one based on a "public interest" view are obvious. In the public interest perspective, leaders deregulate to improve social welfare, the ultimate goal of policy, when it becomes evident it is the optimal strategy. I contend, on the other hand, that they deregulate when political conditions make providing for the public interest the best means of retaining power and generating revenue. Nevertheless, as both explanations suggest that Spanish politicians sought deregulation to advance collective interests, albeit for different reasons, the task of determining empirically which provides a better explanation is challenging.

Although the data are somewhat consistent with both interpretations, a close reading of the evidence suggests that political, not economic, factors determined the timing and pace of reforms. In the 1960s, some (but not all) technocrats wished to reform the financial system, but could not do so - even as Spain experienced worsening economic problems - until their political superiors decided that deregulation was in their interest. In the 1970s and 1980s, the liberalization process stalled several times (most notably, in 1975-1976 and 1979-1980) despite an increasingly evident need to reform; political events (for example, Franco's death and subsequent political uncertainty) best explain this pattern. The evolution of the scope of the reforms also suggests that political calculations underlay the liberalization process. Policy makers delayed dismantling selective credit policies and reducing taxation of the banking system, even though these steps were obviously necessary, because

[43] For instance, see Fry (1988, 245).

politicians initially did not support those measures. In sum, the calculations of political leaders, not economic conditions or beliefs about financial policy, dictated the course of financial policy.

International Constraints and Opportunities

Recently, a body of work has emerged that argues that international factors have played the critical role in the move toward financial deregulation. Some scholars note that governments often encounter direct pressure from international actors to carry out structural reforms, including financial liberalization.[44] Governments that turn to international agencies for funds to overcome temporary balance of payments problems or initiate structural reforms usually must meet conditionality requirements that include financial reforms, notably the dismantling of credit and interest rate controls (Webb and Shariff 1992). They may also face demands by foreign banks, firms, and their governments to open markets to foreign intermediaries or capital flows.[45] In addition, if a government wishes national banks to expand abroad to take advantage of international capital markets, the norm of reciprocity dictates that it open domestic markets to intermediaries from countries that grant its country's banks access (Pauly 1988).

Another contention is that governments, especially in advanced industrial nations, now find it difficult to control financial activity, particularly transborder capital flows.[46] Some scholars (Goodman and Pauly 1993) argue that banks and firms have become truly global in their activities, making it possible for them to evade government financial controls. This trend has made government efforts to control capital movements more costly and ineffective. It has also increased the influence

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[44] The literature on the role of external pressures in economic policy making is large. Recent work includes Kahler (1992) and Stallings (1992).

[45] For example, see Calder (1988) on Japan.

[46] An excellent review of the literature on this topic is Cohen (1996).

of the holder of non-fixed capital, enabling them to obtain their preferred policy of openness.[47] More generally, because of a variety of factors, including technological innovation, international capital flows now respond to a country's economic policies with lightning quickness, placing serious constraints on governments who wish or need to attract capital or prevent its flight. This increasing capital mobility is forcing international convergence across countries toward similar macroeconomic policies and more open financial systems with less government intervention.[48]

Applied to Spain, those who focus on international factors contend that policy makers deregulated financial markets largely in response to or in anticipation of EC regulations. In addition, some scholars note that Spain twice received lines of credit from the IMF to carry out stabilization programs and foreign banks and governments pressured Spain to open its markets to foreign intermediaries.

Serious international constraints on governments clearly exist, but they are not so great that financial policy simply responds to international trends. Even when international constraints are direct and pressing, (for example, when countries negotiate to obtain official aid), political leaders will evaluate how financial liberalization will affect their ability to achieve their own goals. In deciding whether to open markets, politicians will assess the merits of forgoing the political advantages of closure - greater control over credit allocation and appeasement of domestic banking interests - to obtain the benefits of deregulation. In his study of financial opening in four advanced industrial countries, where pressures to open markets are probably greatest, Pauly (1988, 154) concluded: "No state was required to admit or legitimate the direct presence of foreign banks. . . . Idiosyncratic domestic structures mediated between common [international] pressures and changing national policies."[49] Finally, if controls on transborder capital flows are

[47] Frieden (1991a), Gill and Law (1989), and Kurzer (1993).

[48] Andrews (1994), Cerney (1993), and Kurzer (1993) make this argument.

[49] More generally, Pauly (1988, 2) contends: "Politics within distinct state structures remains the axis around which international finance revolves."

removed, other forms of financial deregulation will not necessarily follow. Studies suggest that countries that liberalize vis-a-vis external markets often retain other financial controls (for example, interest rate and credit controls) to dictate how foreign flows are allocated and manage the money supply; indeed, the financial policy mix in countries that have begun to liberalize vis-a-vis external markets remains very diverse.[50]

International factors help to explain certain features of Spain's experience with financial liberalization, but not the decision to pursue reforms itself. International agencies like the IMF provided advice and (unused) lines of credit in support of some economic reforms, but Spanish policy makers had already decided to undertake financial deregulation. External pressure to open Spain's financial system helped pave the way for foreign intermediaries to enter, but mostly by providing deregulation proponents with an additional weapon in their on-going internal battles over policy. Finally, although Spain's integration into the EC contributed to some financial reforms in the mid to late 1980s, it cannot account for most of the evolution of its financial policy.

I elaborate upon these points in greater detail in the section that follows. This section examines financial deregulation in Spain in light of the theoretical debates outlined above. In particular, it elaborates upon the argument that policy makers sought financial liberalization when they gained an incentive to provide better economic performance as a means of obtaining broad-based political support.

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[50] For example, see Cole and Wellons (1989) on Indonesia. Cole and Wellons (1990, 69-84).

Deregulation under Franco: Social Stability and the Search for Efficiency

The Franco regime became interested in financial deregulation in the late 1960s after growing unrest among the working class, students, and Church officials, fueled in part by disillusionment with economic policy, led to an increase in political opposition. This dissent did not threaten the regime's immediate stability, but it deeply preoccupied its leaders.[51] They decided that the best way to defuse the mounting political protest and safeguard the regime's long-term legitimacy was to take steps to sustain rapid economic growth. Prosperity would create a depoliticized populace willing to accept an increased standard of living in lieu of political liberties.[52] Signs that growth was slowing and that economic institutions, particularly the financial system, were not operating efficiently, also acted as a catalyst for reform efforts.

The most influential proponent of the strategy of relying on economic growth to secure broad-based political support was Carrero Blanco, the regime's number two man. Concern over growing dissent and the political fallout from the "Matesa Affair" allowed Carrero Blanco to introduce via a cabinet reorganization in 1969 a new economic team that began to pursue limited structural reforms that would increase economic efficiency and growth, but not be too disruptive politically.[53] Given some freedom to maneuver, policy makers in the MOF and Bank of Spain (BOS), the central bank, decided that a more market-based financial system could help achieve those goals and improve monetary control. Consequently, in 1969 and throughout the early 1970s, they undertook several limited reforms aimed at reducing market segmentation and improving the structure of interest rates. In 1974, the MOF implemented a reform package that increased competition within the financial sector and removed some interest rate controls, but significantly, did not reduce state control over

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[51] See Payne (1987, 554-60), and Preston (1986, ch. 2).

[52] Preston (1986, 11, 23-25).

[53] On the cabinet shake up and the "Matesa Affair," see Payne (1987, 543-48).

credit allocation or discriminatory taxation of the financial sector.[54] Banks opposed the reform package but did little to block it, primarily because the MOF offered them compensation in the form of higher interest rates on loans they had to provide to privileged sectors.[55] In supporting a degree of liberalization, regime leaders calculated that obtaining the acquiescence of dissident groups through better economic performance was worth losing some support among banks.

Financial reform was not inevitable. Policy makers could have chosen to work strictly within the interventionist apparatus the state had created over the years; in fact, in the past policy makers had dealt with economic problems by tinkering with rather than eliminating financial controls, mainly because regime leadership opposed liberalization for political reasons. Exposure to economic doctrine promoting a more market-based financial system helped to shape the content of the reforms, but it was not a decisive factor. Starting as far back as the late 1950s, international agencies and leading Spanish economists had repeatedly told policy makers that Spain's financial system was inefficient and should be reformed along more market-oriented lines;[56] in fact, several proposals for financial reform had circulated within the MOF, the BOS and other ministries. Policy makers pushing reform were only able to act on their ideas when their political superiors decided it was in their own political interest. In sum, new ideas played only a permissive role in the reform process.

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[54] Policy makers did not eliminate selective credit policies because the regime traditionally had used them to channel benefits to important constituents, and this continued to be a central element of the regime's strategy for retaining power. They did not reduce taxation of the financial sector because state spending was beginning to expand at the time and other means of taxation were still politically unacceptable.

[55] Interview with a former banker, July 1990, Madrid.

[56] See Fuentes Quintana (1989), International Bank for Reconstruction and Development (1963), and OECD (1966, 1969).

Financial Reform After Franco: The Transition to Democracy and International Constraints

The Transition to Democracy

The first post-Civil War democratic elections in Spain took place in June 1977. They followed a rapid succession of political reforms in late 1976 and early 1977 that permitted democratic institutions to emerge after Franco's death in 1975.[57] One of the key events was the negotiation of an electoral law. Different political groups favored the adoption of different electoral rules in accordance with their estimations of the size and geographical distribution of their respective blocs of supporters.[58] Nevertheless, Spain's politicians also collectively hoped to create institutions that would ensure the consolidation of democracy. Their challenge was to strike a "difficult balance . . . between the need to create a party system conducive to stable government and the need to represent the interests of significant political and social groups."[59] In particular, politicians wished to create electoral institutions that would prevent excessive fragmentation and a return to the political and social conflict that tore Spain apart in the 1930s and contributed to the Civil War.[60] The desire to avoid repeating the past served as a powerful constraint on simple self-interest maximization by future party leaders.

The electoral law of March 1977 represented a compromise among the conflicting demands of the various parties. To promote the legitimacy of the new democracy, the law embodied broad PR principles so that all major groups would have a voice in the democratic process. Voters would cast ballots for closed and blocked party lists in each district, and each party's share of the vote would

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[57] On this period, see Gunther, Sani, and Shabad (1988, chs. 2 and 3), and Preston (1986, ch. 4).

[58] Gunther (1989, 838).

[59] Ibid., p. 837.

[60] See Gunther, Sani, and Shabad (1988, ch. 3), and Pérez Díaz (1990, 19-23).

determine the number of seats it returned from that district in the Cortes (Congress). However, several "correctives" were introduced to reduce party fragmentation that might impede energetic, purposeful state action.[61] First, the law established a minimum threshold of votes for obtaining parliamentary representation (three percent of votes in the given district). Second, many small electoral districts were created (mostly corresponding to the provinces), each with a minimum of three representatives. Third, the D'Hondt "highest average" method of seat allocation was chosen.[62]

The overall effect of the correctives was to penalize small, sectarian parties, and encourage the emergence of large, all-encompassing national parties that sought broad-based national constituencies.[63] Parties had a strong incentive to appeal to the collective interest because they could not obtain sufficient electoral support by targeting narrow constituencies.[64] Most of the newly-created major parties, in fact, eschewed a strategy of developing close ties with select social groups and adopted "catch-all" electoral strategies featuring platforms that stressed collective goods in the first and succeeding elections.[65] Closed and blocked party lists gave party leaders a means of controlling individual party members, greatly attenuating the role of home districts in determining parliamentary behavior.

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[61] See Gunther, Sani, and Shabad (1988, 45), for details on these correctives.

[62] The D'Hondt method allocates seats to parties on the basis of highest average. The highest average is obtained by dividing the number of votes received by a party by the number of seats already obtained plus one. The party with the highest average is awarded the seat, and the process is repeated until all seats are assigned. See Lijphart (1994, Appendix A) for more on the mechanics of the D'Hondt method.

[63] The D'Hondt method severely penalizes small parties unless district size is very large or the party system is highly fractionalized. These conditions generally do not hold in Spain. See Gunther (1989, 838-41). Stepan and Linz (1992, 127) also point out that Spain's first elections were union wide, not regional. They argue that if regional elections had come first, "the incentives for creation of all-union parties and an all-union agenda would have been greatly reduced."

[64] There were two important exceptions. Regional parties in the Basque Country and Cataluña succeeded by concentrating on the nationalist concerns of voters in these regions. The framers of the electoral law provided regional parties with the opportunity for sufficient representation (by making the province the primary electoral district) to avoid greater tensions between the central government and the Basque Country and Cataluña.

[65] See Gunther, Sani, and Shabad (1988).

Electoral laws alone, however, cannot entirely explain why Spanish politicians created parties that sought to build broad-based, national constituencies through the provision of collective goods, as they are only one determinant of political behavior. Variables associated with Spain's general political environment must also be considered. As already noted, Spanish politicians placed a premium on economic and political stability and energetic state action because they feared a return to the divisiveness and policy incoherence characteristic of the 1930s. These concerns, of course, had contributed to the choice of Spain's electoral institutions in the first place. For their part, Spanish voters, who were normally distributed across the political spectrum, had a pragmatic orientation toward public policy that stressed good results, not particular content.[66] They viewed parties that favored public policies that seemed to benefit only select groups as illegitimate, because such an orientation reminded them of the arbitrariness and favoritism of much government policy during the Franco years. Under these conditions, appeals to the general interest became the optimal electoral strategy for all but the regional parties.[67]

The Spanish electorate placed great weight on overall national economic performance in their evaluations of the political class. The strongest evidence of this consists of an in-depth study of the determinants of support for the government in the 1980s. It revealed that voters' perceptions of the efficacy of economic policy best explained their level of support for the government (McDonough et al. 1986). Significantly, perceptions of collective economic conditions were more important in explaining support than economic conditions viewed in personal terms or "traditional" factors such as religious identification.

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[66] See McDonough et al. (1986). For instance, the electorate generally lacked economic policy preferences derived from firm partisan identification; however, it did hold the government responsible for economic prosperity.

[67] Gunther (1989) cautions that Spanish parties did not always follow strategies that were consistent with the incentives inherent in the electoral law. Several intervening factors - for example, ideological or programmatic incompatibility with potential coalition partners - sometimes led party leaders to place other concerns above the short-term maximization of parliamentary representation. His work demonstrates that electoral laws provide only constraints and incentives, not the determinants of behavior. However, it should be noted that parties that did not respond appropriately to electoral constraints suffered huge defeats; this suggests that the electoral system forces parties to behave "rationally" if they wish to be major participants in Spanish politics and shape the country's economic policies.

The UCD (Unión del Centro Democrático), a centrist-conservative party headed by Adolfo Suárez, won the 1977 elections and formed a single-party minority government. The UCD clearly responded to the new set of political incentives created by Spain's institutional change in designing its initial economic program.[68] The overall shape of the UCD's economic strategy became clear when Suárez appointed Enrique Fuentes Quintana to be the Vice President for Economics. Fuentes was a well-known economist with little political experience. In fact, he did not belong to any political party; this highlights the fact that Suárez chose him for his economic expertise. In the past, he had aggressively advocated more market-oriented economic policies from his post as director of a prominent think-tank, the Foundation for Economic and Social Studies. Several months before his appointment as Vice President, he had criticized the government's economic policies and outlined an ambitious program of stabilization measures and structural reforms in a published interview that had received a great deal of attention.

The UCD government quickly implemented a stabilization package to rectify internal and external imbalances, and outlined a package of ambitious structural reforms, including significant financial deregulation, to improve the economy's long-term efficiency and competitiveness. Authorities planned to carry out some structural reforms immediately, and others in a few years time.[69] Spain's economic problems at the time - moderately high inflation, balance of payments problems, stagnating growth, and high unemployment - in fact required forceful measures.[70] The existence of economic problems cannot account for the decision to pursue reforms, however. Spain

[68] Maravall (1993) and Pérez Diaz (1987) assert that the UCD eschewed structural reform. I contend that top UCD leadership wanted to implement broad reforms, but had to retreat in several areas (for example, industrial restructuring) because of the party's weakness, lack of a parliamentary majority, and the continuing strength of vested interest groups. Interviews (1990 and 1992, Madrid) with top UCD officials, including three former Vice Presidents, confirm this view. The UCD achieved major reform in several important areas, notably in financial, fiscal, monetary, and trade policy. Extensive reforms in these areas cast doubt on the view that the party avoided structural reforms.

[69] See Fuentes Quintana (1983, 121). The IMF provided a line of short-term credit (unused) to ease Spain's balance of payments problems, but did not influence the decision to implement a stabilization package and structural reforms. See Muns (1984, 63).

[70] See Martinez Méndez (1982) for details. Nevertheless, Spain's economic problems in this period were in many ways typical of those facing other European nations.

had recently experienced several periods of poor performance without seeing reform. Some of the measures implemented in 1977 had been on the table for several years, but had languished because policy makers were paralyzed by the political uncertainty surrounding Franco's death.

The UCD's financial reforms marked a dramatic shift in Spain's financial policy. They reduced government control over interest rates and (more significantly) credit allocation, increased competition among intermediaries, and more fully integrated the Spanish financial system into international capital markets. Thus, the reforms were designed to create more efficient financial markets while actually reducing the ability of public officials to deliver private benefits through the financial system. This represented an attempt to capture political support by supplying collective not private economic goods. Of course, the UCD also hoped that deregulation would secure the support of groups that would obtain access to credit (for example, small businesses) once financial controls were lifted as well as that of the general populace which would benefit from financial deepening in the way of deeper mortgage markets and the diversification of savings instruments.

The UCD also viewed the removal of interest rate and credit controls as a way of defusing charges (stemming from the presence of several former Franquist officials in the party) that it was closely tied to vested interest groups and would promote their interests. The opposition, on the other hand, saw liberalization as a means of impeding the UCD government from using its interventionist capacity in financial markets to consolidate its hold on power. More generally, the political class as a whole had an incentive to remove interest rate and credit controls in order to close a channel of disruptive and insatiable social demands. After democratization, it was clear that the government would have to respond to pressure for preferential credit from a much larger set of constituents. If leaders did not provide such credit to all those who demanded it, excluded groups might turn hostile to the democratic process; if they did, they would place impossible demands on state resources and severely distort the functioning of financial markets.

If Spain's transition had resulted in a different set of electoral institutions, significant financial reform, particularly the removal of interest rate and credit controls, might not have occurred. For instance, if the transition had led to an electoral system that rewarded parties with close ties to narrow constituencies, politicians would have had an incentive to maintain existing selective credit policies, or even expand them, so that they could direct preferential finance to important constituents. In several countries, (for example, Brazil) selective credit policies actually did expand after redemocratization.[71]

Without the benefit of a parliamentary majority, the UCD also sought and obtained the cooperation of other political parties and labor in carrying out its economic reforms. This consensus-building process resulted in the signing of the "Moncloa Pacts," an agreement in which Spain's major political actors expressed their support for the process of economic adjustment and political reform. In obtaining this agreement, the UCD capitalized on the widespread fear among politicians that a prolonged economic crisis could destabilize Spain's fragile new democracy and invite military intervention. Although politicians concurred that basic economic reform was necessary, there was not a consensus on what shape it should take.

Fuentes facilitated the implementation of the financial reforms by creating a new ministry, the Ministry of Economics (MOE), and granting it most authority over financial and monetary policy. The insulation of a hand-picked group of well-trained policy makers in the MOE made it easier to circumvent anticipated bureaucratic and private resistance to deregulation.[72] Insulation from social pressures was needed because the reforms faced stiff opposition from the beneficiaries of Spain's restricted financial system, particularly banks and firms receiving preferential credit.[73] Although the MOF had generally supported financial liberalization in the past, it had shown

[71] See Armijo (1993) and World Bank (1989, chs. 4 and 9).

[72] In other economic policy areas, would-be reformers with less autonomy faced resistance that made fundamental change impossible. See Lancaster (1989) and Pérez Díaz (1987).

[73] Opposition to the reforms is documented in Lukauskas (1997).

ambivalence on certain key reforms because its multiple responsibilities sometimes gave it conflicting interests.[74]

After 1978, the UCD's commitment to economic adjustment weakened as it confronted internal party divisions, continuing economic problems and urgent political reforms.[75] In 1978, Fuentes resigned his post in protest over slow implementation of some economic reforms, thereby removing the driving force behind the UCD's early economic strategy. The new Vice President for Economics, Abril Martorell, decided, perhaps appropriately in some issue areas, that structural reform should proceed at a gradual pace until economic conditions improved.[76] Moreover, the UCD government faced many daunting political issues, including drafting a new Constitution, creating a framework for regional autonomy, coping with a sharp rise in terrorism and establishing better civilian control over the military, which required its immediate attention and most of its political capital. It realized that it could not obtain a political consensus for a more radical set of economic reforms under these conditions, a consensus it needed since the party lacked a parliamentary majority. Nevertheless, the government did not repeal any of the financial reforms already passed (although their pace of implementation slowed); in fact, it carried out several others, most notably authorizing new entrants into the financial sector and granting the central bank greater autonomy.

The halt in the reform process was largely predictable. Under the best of circumstances, structural reform is difficult to sustain because it entails high short-term costs and produces benefits only in the long-term. The task of sustaining reform was especially difficult in this case because the

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[74] For example, while the Financial Policy Directorate favored further liberalization of interest rates, other departments with the MOF (for example, the Treasury) opposed it because it would increase the government's cost of issuing debt.

[75] See Martínez Méndez (1982) for details on the economic crisis. See Caciagli (1986) and Gunther, Sani, and Shabad (1988) on the UCD's internal crisis.

[76] José Luis Leal (1982), a former Minister of Economics, has argued that the decision to decelerate the process of structural reforms was warranted on economic grounds. In the area of financial policy, several proponents of deregulation, for example, Mariano Rubio, Sub-Governor of the BOS, also favored a more gradual process, at least until economic conditions stabilized.

UCD had characteristics that limited its ability to act as a reformist party. It was formed out of the merger of several political groupings whose leaders, many formerly part of the Franco regime, had independent bases of power derived from close ties to vested economic interests. This made it difficult for reform-minded party officials to carry out tough economic measures, since social groups that opposed them - banks and large industrial firms - had a voice within the government. These groups hotly protested the initial round of structural reforms, and threatened to withdraw their electoral support if the UCD implemented additional measures. Significantly, the party continued to avoid catering to vested interests; however, their threats constrained its range of action.

In 1981, the UCD reopened the process of structural reform, including financial deregulation, out of recognition that Spain's worsening economic problems and its lack of action in dealing with them were costing it votes. A reshuffling of the cabinet in 1980 moved outspoken economic reformers, Juan Antonio Garcia Díez and Leopoldo Calvo Sotelo, into the posts of Minister of Economics and Vice President of Economic Affairs respectively. The government introduced a major financial reform package in January 1981 and implemented other liberalizing measures in the following twelve months. These measures further liberalized interest rates, increased competition among financial entities, authorized several new intermediaries, implemented stronger prudential regulation, and took the first real steps toward expanding direct financial markets. The UCD's efforts were too little too late since it was soundly defeated in the 1982 general elections.

The Socialist party (PSOE) won an overwhelming parliamentary majority in the 1982 elections. Many political observers anticipated that the PSOE would follow a course of heavy state intervention in the economy. Instead, it greatly reinforced the process of economic adjustment, including deepening financial deregulation, despite resistance from an important segment of the PSOE itself and traditional constituents like labor.[77] In the financial policy area, over the course of the 1980s the Socialists completely liberalized interest rates, dramatically reduced state control over

[77] See *El País Internacional*, Sección Revista, March 18, 1991 for a succinct discussion of the divisions within the PSOE on economic policy.

credit allocation, actively promoted direct financial markets, further increased competition in the financial sector, and integrated Spain's financial system into international markets.[78]

In seeking reforms, the PSOE responded, as the UCD had, to the incentives embodied in Spanish political institutions to eschew the provision of benefits to particular social groups, and instead improve general economic performance to capture broad-based support. Two additional factors deepened the impetus toward financial reform. The first was the continuing seriousness of the Spanish economic situation.[79] The second was Spain's impending entry into the EC; this topic is treated in depth below.

The PSOE was much better equipped to achieve substantial reform than the UCD. In addition to enjoying a parliamentary majority, the PSOE benefitted from a relative lack of close ties to powerful private economic actors with an interest in maintaining the economic status quo. Although the PSOE was associated with a major union, the UGT, it attempted to keep it at arms length when formulating economic policy. If anything, the PSOE's ties to labor gave it greater credibility when seeking reforms that demanded sacrifices by labor. Thus, differences in constituencies affected the ability of the UCD and PSOE to carry out reforms. Finally, most of the steps necessary to complete the consolidation of democracy had been taken, and leaders could devote more political capital to economic reform.

The PSOE's financial policy also responded to another incentive created by Spain's transition to democracy. The transition unleashed pent-up demands for greater government spending on social and welfare programs as well as redistributive claims. The UCD increased government expenditures to provide a badly needed social "safety net" and buy social and political peace during the difficult transition years. Unfortunately, the government's ability to raise revenues through orthodox means could not keep pace with higher expenditures, and this led to large and rapidly growing budget

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[78] See Cuervo García et al. (1988) on these reforms.

[79] See López Claros (1988) for a succinct discussion.

deficits.[80] Moreover, political constraints made it difficult for the UCD to introduce more efficient means of taxation. As a result, the government met deficits by borrowing from the central bank and increasing taxation of the banking system.

Top PSOE policy makers, notably the Minister of Economics, Miguel Boyer, took office determined to introduce a sounder fiscal policy. In particular, they believed that taxation of the financial sector had to be eliminated if the Spanish economy was to achieve sustained long-term growth. In the short term, however, the difficulties of implementing higher direct taxes and a value-added tax to pay for greatly expanded government services led them to intensify taxation of the financial sector. This policy exacted a heavy toll. By the mid-1980s, the efficiency costs of taxing the financial sector had grown so large that they were impeding growth and hurting the economy's long-term prospects.[81] The Socialists realized that unless they implemented a more effective means of raising revenue (and cut spending), the state might soon face a fiscal crisis since budget deficits continued to grow at a very rapid pace. Consequently, the PSOE redoubled its efforts to implement progressive income and value-added taxes, and began to eliminate indirect taxation of the financial sector. Although increasing direct taxation was difficult, the transition had generated social pressure for a more equitable distribution of the tax burden which the Socialists mobilized in their efforts.[82]

In summary, the transition to democracy ushered in institutions that provided Spanish politicians with an incentive to supply more efficient markets. The UCD initially responded to this incentive, but could not carry out its reforms effectively, in part because of its party structure and a lack of a parliamentary majority. The PSOE also recognized the political utility of creating more

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[80] Government expenditures as a percentage of GDP jumped from 22.5% in 1974 to 40.6% in 1985. Social spending alone rose by 215% from 1978 to 1982. See López Claros (1988) for details on Spanish fiscal policy.

[81] The OECD (1987) estimated that taxation of the financial sector annually generated inefficiency costs of approximately 0.5-1.0% of Spain's GDP in the mid-1980s.

[82] When the PSOE entered office in 1982, the deficit as a percentage of GNP was 5.6%; after reaching a high of 6.7% in 1985, it dropped to around 3% in the late 1980s (about the OECD average). Government budget deficits rose again in the 1990s, creeping back over 6%, as Spain suffered through a period of slow growth. Banco de España, *Boletín Estadístico*, various issues.

efficient markets; it was able to implement its reforms because of its strong position in parliament and freedom from constricting ties to vested private interests.

Foreign Banks and Spain's Entry into the European Community

International factors played a role in Spanish financial deregulation. Liberalization proponents within the government used pressure by foreign banks in the mid-1970s to overcome opposition to a limited opening of Spanish markets to foreign intermediaries. Later, Spain's obligations under its treaty of accession to the EC required it to open further its markets to foreign intermediaries. No other form of international pressure was very important in the Spanish case.[83]

Foreign banks obtained permission to enter the Spanish market in 1978 after several years of vigorous lobbying. The MOF had sought to authorize the entry of foreign intermediaries several times in the mid-1970s, but banks had blocked their efforts by pressuring top ranking government leaders. Proponents of opening Spanish markets used foreign lobbying to break down lingering opposition to liberalization among government officials.[84] Continued fierce opposition from Spanish banks, however, forced the MOF to limit the presence of foreign banks and their range of activities.[85] Foreign banks still succeeded in making their presence felt in a variety of ways, notably by introducing

[83] Spanish policy makers interacted with several international agencies, notably the IMF and OECD. As noted earlier, the IMF provided advice and an unused line of credit in support of the stabilization and structural adjustment program implemented shortly after the first elections. However, the decision to pursue reforms was clearly made independent of IMF influence.

[84] Interview with a former MOE official, February 1990, Madrid.

[85] Foreign banks could only open three branches in Spain. In addition, only a third of their operating capital could be raised by accepting deposits from Spaniards. One former MOE official told me that the new foreign banking regulations generated the greatest bank opposition of any reform in the late-1970s. Interview with a former MOE official, February 1990, Madrid.

new technology and financial instruments. However, the limits placed on their activities did not allow them to become major competitors to Spanish intermediaries.

Spain's entry into the EC had a more significant impact on its financial policy. It officially joined the EC on January 1, 1986, but its influence on Spanish policy had started years before. In the early 1960s, some government officials already believed that Spain's economic institutions would have to become more like those of other European countries if it was to be able to compete internationally; in this sense, the EC served as a focal point for thinking about modernization. Spain applied for EC membership several times, but was rebuffed due to EC displeasure over the political situation in Spain. The transition to democracy finally opened the door to membership, and its application was formally accepted in 1977.

As discussed previously, some scholars have argued that Spain's accession into the EC is largely responsible for its ambitious economic adjustment efforts, including financial deregulation. They suggest that the need to meet EC standards in a variety of economic policy areas as well as the need to improve the country's competitiveness in European markets once admitted explains the push for basic economic reforms. This argument, however, treats integration into the EC as exogenously given, whereas the decision to enter the EC was in fact an endogenous policy choice, prompted by a fundamental political motive: the drive to improve economic performance in order to generate broad-based political support.[86] Moreover, this argument implies that Spanish policy makers were only willing to undertake economic reform when highly constrained by external factors, a view that ignores the influence of domestic politics. In the most extreme versions of this argument, the push to enter the EC explains all Spanish economic reforms, even those taken years ago when the prospects of entry were remote; this is highly problematic, for numerous factors have clearly influenced the country's policy.

[86] This is not to undervalue the other motives behind the Spanish drive for EC membership. The Franco regime, for example, also sought entry into the EC as a means of gaining legitimacy in the eyes of the international community; the UCD and PSOE viewed accession as a means of consolidating democracy and being recognized as "a part of Europe."

In addition, the impact of Spain's accession on its economic policy varied greatly across policy domains. It was not great in the area of financial policy. Spain did have to adopt EC rules on financial matters, and these were more liberal than Spanish regulations in the areas of foreign banking and transborder capital flows.[87] This constraint intensified and deepened liberalization in these areas in the mid-1980s, but it does not account for the bulk of Spain's deregulation efforts, which occurred well before Spain agreed to abide by EC rules. Furthermore, Spanish reforms cannot be attributed to policy makers anticipating EC requirements to facilitate acceptance into the Community.[88] EC financial regulations could only be considered comprehensive and restrictive after the Community issued its "Second Directive" in 1989; until that time, they were ambiguous and limited in scope, granting countries considerable leeway in setting financial policy.[89] Three leading authorities on the Spanish financial system state this clearly:

> In contrast with other policy areas, such as the Customs Union or Common Agricultural Policy, in the financial policy domain there is a great diversity of institutions, financial structures, and legal frameworks, leading to multiple differences across EC countries. It would be wrong, therefore, to think that the EC has a common financial policy with uniform rules; there is not a common banking market, and certainly not a common financial market . . . .[90]

Finally, the most important Spanish financial reforms, at least until the mid-1980s, were concentrated in areas where the EC simply did not have rules (for example, interest rate policy).

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[87] See Cuervo García et al. (1988) and Gil (1985) for discussions of EC regulations and their impact on Spanish financial policy.

[88] All the economic policy makers I interviewed (1989, 1990, 1992) asserted that Spain's wish to enter the EC was of lesser importance in shaping financial policy than the more basic motives of improving efficiency and monetary control. They affirmed that EC rules did influence policy in other areas (for example, commercial policy) before Spain's entry into the EC.

[89] The EC's "White Book" on financial service liberalization, a set of proposals which served as the basis for the Second Directive, was published in 1985.

[90] Cuervo García et al. (1988, 254).

In any case, Spain's financial regulatory regime resembled that of other EC countries throughout much of the post-war period. If anything, according to three Spanish economists writing in 1988, "Spain is much further along than many other EC countries in the process that would be needed to create a common banking system."[91] Certainly, the Spanish government began carrying out major reforms in critical areas of financial policy (for example, the removal of credit and interest rate controls) before many other EC countries (for example, France).

In short, Spain's financial reform process was set in motion for reasons not directly related to meeting EC demands; one must examine domestic political incentives to explain why policy makers deregulated markets. Nevertheless, as already noted, we can attribute some post-1985 reforms directly to Spain's entry into the EC. The most significant impact was further opening of Spanish markets to foreign intermediaries. After a brief transition period, Spain could no longer discriminate against banks from other EC countries. It also had to adopt EC standards on the establishment of intermediaries issued in the "First Directive," although it was given a grace period.[92] The unrestricted entry of foreign banks was a frightening prospect for Spanish banks; moreover, it was not counter-balanced by the promise of profitable expansion into EC countries, as they were less efficient than European banks in almost every respect.[93]

Spanish authorities also had to liberalize capital flows with EC countries by 1992. At the time of its entry, Spanish capital controls were fairly typical of those of other EC countries. In fact, the removal of capital flows was a thorny issue for all EC members, since there was not a uniform rate

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[91] Ibid., p. 285.

[92] The EC issued the First Directive in 1977. The Directive "was not an important step in the process of harmonizing legislation across EC countries because its scope was limited and its principles vague." Cuervo García et al., (1988, 257). Spanish policy makers passed several regulations to comply with the First Directive in 1985.

[93] Operating costs represented 3.3%, 2.1%, and 2.0% of total assets for Spanish, Italian, and French banks respectively in 1983. *Actualidad Económica*, December 20, 1984. Spanish banks were much smaller than most European banks. To the extent that economies of scale are important in banking, this left Spanish banks at a competitive disadvantage. See *Noticias CEE*, November 1985. For a realistic analysis of the prospects of Spanish banks by a Spanish banker, see Boada Vilallonga (1985).

of taxation on financial assets within the EC. Spain actually liberalized many types of capital flows before 1992; for example, it removed most restrictions on direct investment in 1987. In addition, to enable Spanish intermediaries to compete on equal footing with foreign intermediaries, authorities eliminated restrictions on the type of international transactions that they could perform.

Finally, EC accession provided a greater impetus to the ongoing reform of Spanish bond and equity markets. Although Spain faced no legal requirement to reform its direct markets, Britain's "Big Bang" in 1986 meant that Spain would only be able to compete effectively with Britain's (and other EC countries') bond and equity markets for funds once capital controls were removed unless it also carried out reforms.

Ultimately, perhaps the most important impact of Spain's entry into the EC on financial policy was that it gave liberalization proponents another tool to overcome opposition to further financial deregulation. Policy makers could point to EC standards (where they existed) as external constraints. They also could raise the specter of eventual competition from more efficient European intermediaries to build support among Spanish banks for reforms that would increase their long-run competitiveness.

Conclusion

This paper argues that politicians deregulate financial markets when the political utility they derive from a restricted system decreases relative to that of a more market-based system. Market-based systems are most useful when politicians have an incentive to supply collective goods, such as efficient financial markets, in the pursuit of power and they can generate revenue through efficient means of taxation. Consequently, to understand deregulation in restricted systems, one must explain what leads politicians to conclude that establishing more efficient markets is essential for staying in power, and why they are able and willing to forego the government revenue that restriction can generate. A focus on similar analytic issues may help to explain other types of structural reform once the specific characteristics of other sectors are considered.

I contend that the depth of a financial system influences whether the push for deregulation will come from private groups or government officials. In other words, market structure helps determine whether a society- or state-centered approach is most appropriate in analyzing financial policy. Where banks are the only significant type of intermediary, public officials will be the driving force behind liberalization, and they will seek it for reasons that are independent of interest group demands. In markets with greater depth, pressure for deregulation usually comes from regulated intermediaries that face unregulated competitors and disintermediation from direct financial markets. Nevertheless, attention to the factors that influence state supply of regulation might also strengthen explanations of deregulation in systems with greater depth, since it was policy makers who allowed unregulated competitors to exist and, therefore, who ultimately created the dynamic that leads to demands for deregulation.

This paper concludes that international factors play an important but not decisive role in financial deregulation. The timing and nature of reforms are still determined by domestic factors, notably the calculations of political leaders, the degree of political competition, and the balance of interest group demands. International factors may be growing in importance however, as barriers to international financial intermediation diminish. In Spain, external constraints were most significant in permitting proponents of liberalization to advance their goal of slowly opening markets to foreign intermediaries. Spain's entry into the EC also led policy makers to step up several on-going financial reforms in the 1980s.

This paper's most important result is that a transition from an authoritarian to a democratic regime promoted deregulation in Spain and that there are good theoretical reasons for believing more generally that democratization may lead to financial liberalization. Nevertheless, democratization will not always provide politicians with the incentive or capacity to create a market-based financial system. Transitions yield varying results because the form of democracy that emerges from a transition greatly influences a government's capacity to initiate and sustain major economic reforms. The political institutions created during Spain's democratization provided a conducive environment in which to achieve structural reform. Its electoral system gave parties an incentive to build a broad-based national coalition, not to provide particular benefits to select social groups. Its turbulent past led the political elite to emphasize cooperative solutions to pressing economic and political problems. Transitions that spawn democracies with institutions that reward parties that build close ties with particular groups will make deregulation less likely.

This study's rational choice hypotheses are able to capture differences in the reward structures presented by authoritarian and democratic regimes and demonstrate how these differences affect economic policy making. But, as the Spanish case shows, they are unable to explain inter-governmental variances in the behavior of politicians facing similar institutional constraints after democratization; these variations must be explained by an entirely different set of factors.[94] The broader implication is that rational choice approaches that seek to explain political behavior solely by specifying the institutional reward structure confronting politicians are bound to be incomplete; they must be supplemented by attention to variables at other levels of the political system and the interactions among them. In the Spanish case, inter-governmental differences stemmed mostly from variations in the government's ability to carry out its agenda, which depended on its parliamentary strength, the nature of its ties to powerful special interest groups, and prevailing domestic and international economic conditions. Another likely source of inter-governmental differences is variation in the ruling party's ideology, although this was not a major factor in the Spanish case.

[94] The limits of the rational choice approach are also seen in the existence of divergent perspectives on overall political and economic strategy within individual parties (that is, the UCD and PSOE), in the Spanish case. Politicians in these parties faced similar reward structures, but their calculations of how to maximize electoral representation sometimes differed. I address this issue in Lukauskas (1997).

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