The big short: An empirical investigation on financialization and the path to democratic backsliding*

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Abstract

This study examines the intricate relationship between financialization and democratic backsliding. Since the 1970s, the global economy has witnessed a significant shift from industrial production to financial channels as the primary source of profit, a phenomenon known as financialization. Concurrently, the world has also experienced a stagnation and regression in democratic processes, characterized by the consolidation of executive powers, erosion of checks and balances, and election manipulation. This paper explores the potential causal links between financialization and the deterioration of democratic institutions. By introducing a novel financialization index, we analyze the direct and indirect impacts of financialization on liberal democracy across 49 countries from 2005 to 2019. Our empirical investigation utilizes panel data analysis to assess the influence of financialization on democracy, considering factors such as the rule of law, clientelism, political corruption, polarization, income per capita, and income inequality. The findings indicate a significant association between the deepening of financialization and declining levels of democracy, thus providing new insights into the political-economic dynamics that shape our world.

Key words

Financialization, democratic backsliding, panel data analysis

Belo Horizonte, Brazil

April, 2024

*The authors would like to thank Professor Marco Crocco for his helpful comments in a previous version of this manuscript. The usual disclaimer applies.

1. Introduction

Since the 1970s, the reversal of numerous autocratic regimes worldwide has triggered a third wave of democratization, especially in Latin American and African countries (HAGGARD & KAUFMAN, 2016). However, from 2006 onwards, global democracy indicators entered a period of stagnation with progressively lower rates of growth. In the subsequent years, this process gained more traction and evolved into democratic regression (WALDNER & LUST, 2018). Therefore, the amplification of executive powers by incumbents, the gradual erosion of domestic checks and balances, and the manipulation of elections have become widespread events in numerous countries around the world (BERMEO, 2016).

While political tensions unfolded worldwide, another phenomenon was emerging: starting from the 1970s, the epicenter of the global economy began to shift from the industrial to the financial sector (VAN DER ZWAN, 2014). Drawing inspiration from classical works of political economy, such as Hilferding's influential *Finance Capital* (1910), scholars widely began to comprehend this phenomenon as financialization. One of the most relevant works in this literature understands financialization as "a pattern of accumulation in which profits primarily accrue through financial channels rather than through trade and commodity production." (KRIPPNER, 2005, p. 3).

When considering financialization as a macro level phenomenon that transforms the political-economic organization as a whole, an important question arises: could financialization play a role in the recent wave of democratic backsliding? Recent theoretical studies have emphasized that financialization directly undermines democracy as it makes governments increasingly reliant on financial sectors, constrains the state's decision-making space, and reduces electoral competitiveness (NÖLKE, 2020; PAGLIARI & YOUNG, 2020). Moreover, the literature review on both phenomena also suggests that the rise of finance indirectly impacts democracy through several political and economic transmission channels, such as political polarization and income inequality.

Upon a more categorical analysis of this body of literature, we identify that empirical studies face a significant challenge in measuring financialization at the macro level. Furthermore, no study had sought to empirically investigate the impacts of financialization on democratic backsliding. Therefore, the contribution of our study to the literature on financialization is threefold. Firstly, we propose a novel financialization index that seeks to account for the rise of the financial sector at the expense of the productive sector. Secondly, we proceed to empirically investigate the impact of increases in our financialization index on liberal democracy. Finally, we estimate the indirect impact of financialization on democracy through other channels; namely, rule of law, clientelism, political corruption, political polarization, income per capita, and income inequality. To do so, we conducted a panel data analysis for a sample of 49 countries over the period 2005-2019. Our results suggest that financialization deepening is direct and indirectly associated with lower democracy levels.

The work is structured as follows. After this introduction, in Section 2 we provide a literature review of democratic backsliding as well as financialization. We proceed with a discussion on how the rise of finance may affect the levels of democracy and introduce several propositions in this regard. Section 3 presents the methods and data used in our analysis and the methodological considerations behind our estimation procedures. In Section 4 we discuss our findings. In Section 5 we provide concluding remarks as well as an outlook on the way forward.

2. Literature Review

2.1 Democratic Backsliding

On January 1, 2012, thousands of people flooded the streets of Budapest in protest against the implementation of Hungary's new constitution. The document reflected the interests of Prime Minister Viktor Orbán, whose tenure has recently shifted towards the implementation of reforms aimed at weakening multiparty democracy, undermining judicial independence, and restricting press freedom. This scenario observed in Hungary is not an isolated experience but rather a symbolic example of an alarming political process observed in the 21st century: democratic backsliding is emerging as a global phenomenon.

Since the 1970s, the reversal of numerous autocratic regimes worldwide has triggered a third wave of democratization, especially in Latin American and African countries (HAGGARD & KAUFMAN, 2016). According to the Freedom of the World Report (GOROKHOVSKAIA *et al.*, 2023), in 1974, only about 30% of all countries could be classified as liberal democracies, but this figure doubled to reach 61% by 2006. In the words of Diamond (2015), "Nothing like this continuous growth in democracy had ever been seen before in the history of the world".[1]

However, from 2006 onwards, global democracy indicators entered a period of stagnation with progressively lower rates of growth. In the subsequent years, this process gained more traction and evolved into democratic regression, characterized by declines in democracy indicators and other democratic components. According to data from V-Dem, the liberal democracy global index has declined significantly over the past decade, to the extent that democracy levels in 2022 reverted to the same levels found in the year 2000. This backsliding can be observed in Figure 1, which displays the evolution of the Liberal Democracy Index from 1970 to 2022 in 182 countries.

This process of democratic backsliding is defined by Bermeo (2016, p.1) as "the state-led debilitation or elimination of any of the political institutions that sustain an existing democracy". This phenomenon implies several economic and political impacts, given that higher levels of democracy are shown to reduce corruption, promote positive effects on health policies, reduce environmental degradation, and promote economic growth (KOLSTAD & WIIG, 2016; MECHKOVA *et al.*, 2017; CHEN *et al.*, 2021; PELKE, 2023). It is also noteworthy that democratic backsliding does not necessarily refer to the reversion of a democracy into an autocratic regime, but rather to various other forms of deterioration of democratic institutions (LUHRMANN & LINDBERG, 2019). According to Wunsch e Blanchard (2023, p. 3):

> "In contrast to the earlier blatant attacks against democracy leading to democratic breakdown, democratic backsliding tends to take more subtle forms, whereby an elected government gradually erodes democratic safeguards to the point of dismantling them completely."

One of the main drivers of democratic erosion is the process of executive aggrandizement, which involves the expansion of executive powers at the expense of other branches of government (BERMEO, 2016). The executive power seeks to increase its influence and control over government institutions through democratic channels, meaning that

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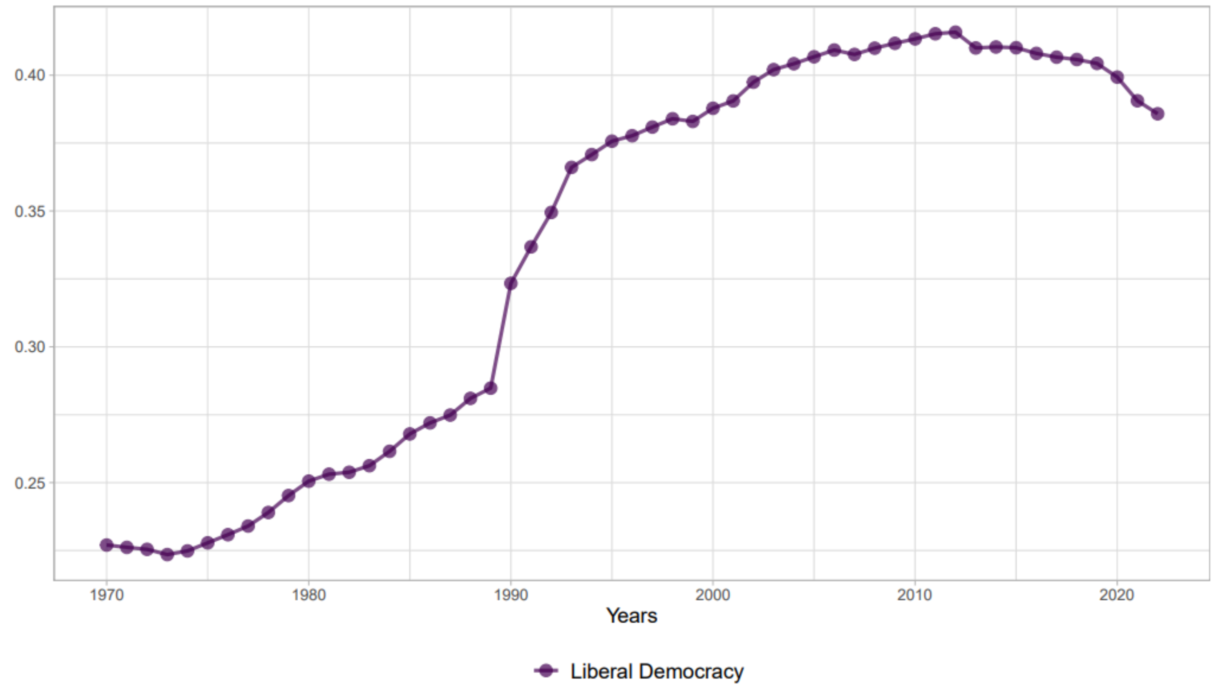
[1] For a more comprehensive discussion on evidence of the recent wave of democratic backsliding, see Bertels (2023, p. 12-27).

"incumbents are able to subvert democracy by exploiting vulnerabilities within the democratic process" (SVOLIK, 2018, p. 3). Ultimately, this causes the erosion of horizontal accountability and of domestic checks and balances.

Figure 1 - Liberal Democracy Index (1970 - 2022)



Source: authors' own elaboration based on data from V-Dem

One of the main drivers of democratic erosion is the process of executive aggrandizement, which involves the expansion of executive powers at the expense of other branches of government (BERMEO, 2016). The executive power seeks to increase its influence and control over government institutions through democratic channels, meaning that "incumbents are able to subvert democracy by exploiting vulnerabilities within the democratic process" (SVOLIK, 2018, p. 3). Ultimately, this causes the erosion of horizontal accountability and of domestic checks and balances.

In addition, Maerz *et al.* (2020) highlight that the first signs of democratic backsliding are often associated with government censorship of the media and limitations on political and civil liberties. Similar to what happens in the process of executive aggrandizement, these episodes of repression also tend to take on a progressively more subtle character and have often happened through democratic channels, such as constitutional amendments and reforms that undermine academic and cultural freedoms, target civil society organizations, and limit media independence (SVOLIK, 2015, MECHKOVA *et al.*, 2017).

Besides executive aggrandizement and government repression, democratic backsliding often involves the reduction of electoral competition through strategic manipulation of elections. This encompasses a wide range of measures, such as altering electoral rules to favor incumbent candidates, intimidating the opposition, and controlling media channels (BERMEO, 2016). In this regard, Svolik (2018) emphasizes that this dynamic significantly weakens democratic institutions and makes them more vulnerable to subversion by elected incumbents - the so-called "executive takeover".

When it comes to identifying the causes of democratic backsliding, there is a growing body of literature assessing the economic and political determinants of democratic backsliding. Table 1 below presents a comparative analysis of the recent empirical studies on this issue:

Table 1 - Recent empirical evidence on the causes of democratic backsliding

Authors	Description	Methodology	Main findings
Chisadza & Bittencourt, 2019	The authors create a composite measure for economic development and test its impact on democracy.	Fixed Effects, GMM, Mean Group Estimator	There is a positive and significant effect of economic development on democracy.
Pérez-Liñán *et al.*, 2019	It investigates the effects of executive's institutional hegemony on democracy.	Discrete-time model	Executive hegemony is a major driver of democratic instability.
Ruth-Lovell *et al.*, 2019	This paper analyzes the effect of populism on democracy.	Fixed Effects	Populist governments tend to erode the level of democracy.
Wietzke, 2019	It measures the impact of household income on democracy in developing countries.	Fixed Effects	Poverty reduction has a small but statistically significant impact on democracy.
Claassen, 2020	This article estimates the effect of public support on democratic stability.	OLS, GMM	There is a positive effect of public support on democratic change.
Jha & Kodila-Tedika, 2020	This study explores the relationship between social media and democracy.	OLS	There is a strong, positive correlation between social media penetration and democracy.
Kwak *et al.*, 2020	This paper examines the effects of regime delegitimation on democratic backsliding.	OLS	The quality of democracy is significantly influenced by the institutional trust among the youth.
Meyerrose, 2020	It tests whether international organizations that support democracy unintentionally promote democratic backsliding.	Fixed effects, OLS	Membership in these international organizations enhances the likelihood of backsliding in new democracies.
Rød *et al.*, 2020	This paper aims to test the impact of income and Islamism on democratization.	Sensitivity analysis	There are lower chances of democratization in countries with large Muslim populations.
Arbatli & Rosenberg, 2021	This study investigates the links between political polarization and democratic erosion.	Fixed effects	Higher polarization is positively associated with erosion of democracy.
Gafuri, 2022	This paper tests how EU-led democracy assistance projects impact democracy.	Fixed effects, GMM	EU's democracy assistance positively impacts democracy in recipient countries.
Kratou & Laakso, 2022	This paper focuses on the causality between academic freedom and democracy.	GMM	There is a positive impact of academic freedom on electoral democracy.

Orhan, 2022	It explores the impact of affective polarization on support for undemocratic politicians.	OLS, Multilevel models	Affective polarization is positively correlated with democratic backsliding.
Bagchi & Fagerstrom, 2023	It investigates the impact of wealth inequality on democracy.	GMM	Politically connected wealth inequality lowers democracy scores.
Berlucchi & Kellam, 2023	This paper evaluates the impact of populist leaders on liberal democracy.	Matching methods, Poisson regression	Populists have a detrimental effect on liberal democracy.
Grumbach, 2023	It tests the impact of party competition, polarization, demographic change, and group interests on U.S. democracy.	Difference-in-differences	Results suggest a minimal role for all factors except Republican control of state government, which reduces democratic performance.
Sato *et al.*, 2023	The analysis tests the effect of disinformation on regime stability.	OLS	In authoritarian regimes, disinformation helps rulers to stay in power, while in democracies, it heightens the risk of autocratization.
Hu *et al.*, 2024	This article estimates the effect of public support on democratic stability.	OLS, GMM, MOC	Public support does not affect democracy once uncertainty is taken into account.

Source: authors' own elaboration

Despite this growing body of literature, multiple uncertainties surround the recent phenomenon of democratic backsliding. In this regard, there is a specific gap regarding our understanding of the role of financialization on democracy. It is worth noting that our extensive literature review has revealed an uncharted territory – no prior study has ventured to empirically measure the relationship between these two variables. Hence, our research holds particular significance, as it seeks to bridge this gap by investigating the direct and indirect effects that financialization may have on democratic backsliding.

2.2 Financialization

The late 1970s saw not only a substantial global shift toward democracy but also profound transformations in the economic landscape. As the Keynesian-Fordist model began to show its first signs of stagnation, scholars noted a significant expansion of the financial sector. This process was evidenced by several indicators, including the exponential growth of indebtedness across various sectors, the increase in international capital flows, and the rising stock market capitalization (PALLEY, 2007; STOCKHAMMER, 2010). Thus the rise of finance inaugurated a new phase of the capitalist mode of production, where the center of gravity of the global economy shifted from the industrial to the financial sector. This phenomenon is widely understood through the notion of financialization, although this concept still lacks a singular consensual definition (MADER *et al.*, 2020).

Epstein (2005) contributes to this literature by defining financialization as "the increasing influence of financial motives, financial markets, financial actors, and financial institutions in the functioning of both domestic and international economies." However, Krippner (2005, p. 3) also addresses changes in the productive sector by defining financialization as "a pattern of accumulation in which profits primarily accrue through financial channels rather than through trade and commodity production." In other words, it can be understood as a process of financial sector growth occurring at the expense of the productive sector. Both definitions point to a macro-level analysis of financialization that reveals a shift in the capitalist accumulation regime and in its macroeconomic aggregates.

Building upon this level of analysis, scholars pinpoint important macroeconomic effects stemming from the process of financialization, which encompasses low economic growth, asset price volatility, diminished investment in tangible assets, stagnation of real wages, and the accumulation of debt (PALLEY, 2007; ORHANGAZI, 2008; STOCKHAMMER, 2012). In the international landscape, financialized capitalism is also intricately connected to the liberalization of capital flows. This, in turn, leads to imbalances in the balance of payments, triggering cycles of growth and recession, and promoting exchange rate volatility (VAN DER ZWAN, 2014). Finally, Aalbers (2019) also highlights the recent trend of financialization of the state, involving the reshaping of governmental entities through market-based refinancing methods and financial market transactions.

Beyond financialization as a macro phenomenon, this process also transforms the functioning of economic systems at micro levels. When analyzing the impacts on firms, the emergence of shareholder value orientation has emerged as the central principle in the corporate policies of non-financial enterprises. This means that the profit of companies is primarily being distributed to shareholders in the form of dividend payouts and share buybacks, rather than being reinvested in the firm's productive facilities (MADER *et al.*, 2020). Empirical studies at the firm level show that shareholder value orientation leads to a reduction in the desired growth rate of firms and in productive investment, while also contributing to downsizing employment and wage stagnation (STOCKHAMMER, 2004; ORHANGAZI, 2008; DÜNHAUPT, 2013).

Finally, the concept of financialization also encompasses the "financialization of everyday life" or "household financialization," which entails the integration of financial activities and products into the daily lives of individuals (LANGLEY, 2008). This democratization of finance involves the incorporation of low-income and middle-class households in financial markets through housing mortgage securitization (AALBERS, 2017), commercialized micro-credit (AITKEN, 2013), pension funds (BONIZZI & CHURCHILL, 2017), and other financial activities. Thus, the lives of workers are increasingly mediated by the principles of the financial sector, which has contributed to the exponential increase in household debt levels, declining savings rates, and an overall rise in financial sector instability since the mid-1970s (STOCKHAMMER, 2010).

The study of financialization reveals an intriguing characteristic: its causes and effects can be explored through different levels of analysis[2]. When examining the relationship between financialization and political variables, however, we adopt a macro-level approach, for which Krippner (2005) and Epstein's (2005) definitions are particularly relevant. In other words, financialization is here perceived as a shift in the accumulation regime of the capitalist mode of production, which, in turn, affects political and macroeconomic variables. In this context, there is an extensive body of empirical literature that seeks to measure the macroeconomic impacts of this phenomenon (e.g. STOCKHAMMER, 2009; GODECHOT, 2016).

Nonetheless, few empirical investigations have sought to measure the macro impacts of financialization on political variables. In fact, an extensive review of this literature reveals

[2] For a more comprehensive literature review on financialization, see Palludeto & Felipini (2019).

that, up to this point, no study has aimed to investigate the effects of financialization on democratic institutions. This gap can be attributed, at least partially, to the challenges faced when attempting to empirically assess these two processes. In the case of financialization, the review of main empirical evidence, as presented in Table 2, reveals a significant divergence among scholars in their approaches to the macro-level analysis of this phenomenon, resulting in the adoption of diverse variables as proxies for measuring financialization.

Table 2 - Main empirical studies on financialization at the macro level and its variables

Authors	**Financialization measures**
Krippner, 2005	Portfolio income to corporate cash flow; financial to non-financial profits
Stockhammer, 2009	Foreign assets and liabilities relative to GDP; real interest rate
Assa, 2012	Employment in finance to total employment; value added by the financial sector to total value added
Kus, 2012	Total value traded in stock market to GDP; bank income before taxes; securities under bank assets
Dünhaupt, 2013	Net interest and net dividend payments of non-financial corporations as a share of capital stock in business sector
Van Arnum & Naples, 2013	Value added by the FIRE sector (finance, insurance, and real estate) as a share of GDP
Godechot, 2016	Ratio of finance and insurance to GDP
Huber *et al.*, 2018	Ratio of total market value of all publicly listed shares to GDP
Hyde *et al.*, 2018	Value added by the FIRE sector as a share of GDP
Barradas, 2019	Value added by the financial sector to total value added
Pariboni & Tridico, 2019	Ratio of total market value of all publicly listed shares to GDP
Li *et al.*, 2022	Financial market efficiency index

Source: authors' own elaboration

This review of empirical literature reveals that studies employ a wide range of variables as proxies for financialization. Nonetheless, they seem unable to establish a quantitative correlation between the expansion of the financial sector and the simultaneous decrease in production levels. Thus, our study aims to contribute to the literature on financialization by introducing a financialization index that can quantify the expansion of finance while accounting for the decline in the productive sector. As a result, we seek to obtain a more accurate measurement of the financialization process as a macro-level phenomenon. Moreover, we provide the first empirical attempt to evaluate the effects of financialization on democratic backsliding.

Next, we explore the channels through which increased financialization may lead to democratic backsliding.

2.3 Financialization and Democratic Backsliding

When addressing the connection between financialization and democratic backsliding, scholars highlight the diverse channels through which the financial sector may impact democracy (e.g. TRAMPUSCH, 2019; NÖLKE, 2020). Thus, we formulate that financialization directly and indirectly impacts democracy levels through political and economic mechanisms. To explore the transmission channels linking financialization and democratic erosion across the globe, a set of propositions are illustrated on Figure 2 and formulated as follows:

Proposition 1: *Financialization directly affects liberal democracy.*

First, the growing process of financialization of the state involves a significant shift towards market-based refinancing methods and financial market transactions, as previously discussed (TRAMPUSCH, 2019). As the public sector adopts market-based principles and mechanisms, it becomes increasingly reliant on financial sectors, thereby encouraging the implementation of market-friendly regulations (PAGLIARI & YOUNG, 2020). Therefore, the higher the financialization of the state, the lower the space for democratically elected governments to formulate public policies to meet the majority's needs.

In addition to the financialization of the state, the continued expansion of the finance sector gives it significant influence over the economy. Many large-scale financial institutions are now deemed 'too big to fail', as there seems to be a political consensus that they should be rescued by the state in times of crisis, despite public opinion (STREECK, 2011). This is the case of the worldwide adoption of strong fiscal stimulus packages and bail-out programs in response to the Global Financial Crisis in 2008. As a result, the scope of the state's decision-making space is constrained by the imperative to maintain financial stability, which undermines the government's capacity to address the needs of the majority (NÖLKE, 2020).

Beyond these mechanisms, the financial sector also exerts significant influence on public policy formulation through its massive lobbying clout (NÖLKE, 2020). The growth in the size of the financial industry has broadened the financial resources that financial firms and associations can deploy to lobby policymakers in the design and implementation of financial regulatory policies (PAGLIARI & YOUNG, 2020). In addition, lobbying also occurs in political processes aiming to influence electoral outcomes, which ultimately reduces electoral competitiveness and undermines the fair and democratic nature of electoral processes.

In short, democracy seems to be directly impacted by financialization through the process of financialization of the state, the influence of large-scale financial institutions, and the lobbying practice that affects both the decision-making and electoral processes.

Next, we seek to explore other mechanisms through which financialization indirectly influences the democratic process.

Proposition 2: *Financialization indirectly affects liberal democracy through the rule of law.*

The financialization of capitalism relies on a set of underlying institutional preconditions, including the rule of law. Therefore, aiming to align the institutional framework with the interests of private agents, the financial sector reshapes the principles of the legal system through the "regulatory capture"[3] of the state (CARPENTER & MOSS, 2013). Overall, regulatory capture undermines the effectiveness of regulatory agencies and can result in policies that prioritize private interests over the public good. Consequently, this impacts democratic accountability and contributes to the erosion of democracy

[3] For a more comprehensive discussion on regulatory capture, see Carpenter and Moss (2013).

(CARRUTHERS, 2015). Thus, financialization may indirectly affect democracy through the rule of law.

Proposition 3: *Financialization indirectly affects liberal democracy through clientelism.*

Clientelism is characterized by the exchange of personal favors in return for political backing (COPPEDGE *et al*, 2023a). In this regard, political parties rely heavily on external resources provided by economic agents often associated with the financial sector (GHERGHINA & VOLINTIRU, 2017). Therefore, financialization enables the funding necessary for clientelistic practices, which have long been associated with poor governance outcomes (SEN *et al.*, 2023). Among its adverse political effects is the decline in democracy levels, given that clientelism reduces democratic accountability, undermines electoral competitiveness, and fragments political parties (HICKEN, 2011). Hence, financialization is expected to indirectly affect liberal democracy through clientelism.

Proposition 4: *Financialization indirectly affects liberal democracy through political corruption.*

The increasing process of financialization of the state is characterized by the incorporation of principles and practices of the financial market into the public sphere's framework (TRAMPUSCH, 2019). This often results in the adoption of complex financial mechanisms that reduce transparency within political finance, thus facilitating corruption (SHKOLNYK *et al.*, 2020). Political corruption, on the other hand, has been extensively connected to lower democracy levels, as it lowers people's trust in the government, squanders public resources and deepens social injustice (DRAPALOVA, 2019). However, it is worth noting that empirical evidence on democracy and corruption yields mixed results, especially regarding the causal directionality between the two variables (SEIM, 2020).

Proposition 5: *Financialization indirectly affects liberal democracy through political polarization.*

From very early on, scholars have stressed that financialization has heightened the disparities in income, wealth, and power (e.g. FOSTER, 2007; STOCKHAMMER, 2012). As a result of these inequities, polarization escalates, often affecting social interactions beyond political discussions (i.e., affective polarization). Polarization, in turn, threatens democracy as it makes governments less efficient, increases the likelihood of significant swings between political extremes, fosters greater popular dissatisfaction, and fuels mistrust toward institutions (HAGGARD & KAUFMAN, 2021; ARBATLI & ROSENBERG, 2021; ORHAN, 2022). Therefore, financialization may indirectly affect liberal democracy through political polarization.

Proposition 6: *Financialization indirectly affects liberal democracy through income per capita.*

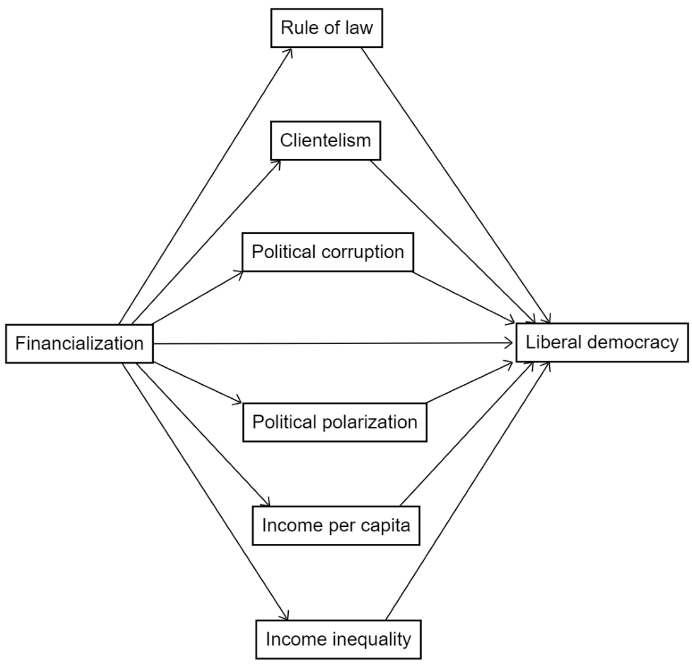
Recent empirical evidence highlights the negative impact of financialization on income, as financialization causes an increased share of GDP to go to owners of financial assets who are focused on immediate financial gains rather than at long-term economic development (ASSA, 2012). In this regard, most scholars argue that lower income is associated with lower levels of democracy, given that democracy arises from a set of institutions that are strengthened by higher income levels, such as education and urbanization

(LIPSET, 1959). Thus, financialization is expected to negatively affect democracy through income. It should be noted, however, that empirical evidence has shown mixed results regarding the relationship between income and democracy (BARRO, 1999; ACEMOGLU *et al*, 2008).

Proposition 7: *Financialization indirectly affects liberal democracy through income inequality.*

Similarly, scholars have long emphasized that financialization is associated with increasing income inequality (e.g., LIN & TOMASKOVIC-DEVEY, 2013). This is primarily explained by the shift in power from labor to capital, resulting in an overall reduction in wages and a subsequent rise in inequalities (STOCKHAMMER, 2012). Higher income inequality, in turn, is associated with lower levels of democracy, as wealthy elites often resist democratization out of fear of redistribution (BOIX, 2003; ASSA, 2012). Therefore, financialization should also undermine democratic backsliding by promoting higher income inequality. However, it is worth mentioning that the relationship between income inequality and democracy is mixed since many studies show that democracies with high levels of inequality also redistribute less (ANSELL & SAMUELS, 2014; MOENE & WALLERSTEIN, 2001; PEROTTI, 1996).

Figure 2 - Possible transmission channels through which financialization impacts liberal democracy



Source: authors' own elaboration

This literature unquestionably demonstrates that there are several transmission channels through which financialization impacts democracy. However, there is still a gap when it comes to empirically testing the extent of these effects. Therefore, the aim of our work is threefold: Firstly, we propose a novel financialization index that seeks to account for the rise of finance at the expense of the productive sector; Secondly, we proceed to empirically investigate the direct impact of increases in our financialization index on democracy; Finally, we estimate the indirect impact of financialization on democracy through political and economic channels; namely, rule of law, clientelism, political corruption, political polarization, income per capita, and income inequality. To the best of our knowledge, this is the first empirical attempt to assess the relationship between financialization and democratic backsliding.

3. Data and Methodology

3.1 Methodology

Our estimations are based on time-series cross-sectional data, covering 49 countries from 2005-2019. To assess the relationship between financialization and the political and economic variables, we use the two-way fixed effects model. In this model, fixed effects are estimated for each unit and each time period, thereby capturing the specific characteristics of each unit and systematic variations over time (WOOLDRIDGE, 2010). The effect of financialization on the political variables is estimated through an equation of the following form:

$$dem_{it} = \alpha_i + \delta_t + \beta_1 fin_{it} + \beta X_{it} + \varepsilon_{it} \qquad (1)$$

where dem is the liberal democracy index observed for country i at time t; fin is the financialization index; X is a vector of all control variables applied in this model;; ε_{it} is an error term that is assumed to be independently and identically distributed with mean zero and constant variance; α_i accounts for country-fixed effects representing possible time-invariant influences at the country level; δ_t is the time-fixed effects that accounts for time-unit specific factors; β_1 accounts for the partial effect of the financialization index on the liberal democracy index; and β is the vector of coefficients associated with the control variables.

To account for potential other effects, we include a set of controls that have been identified as important determinants of democratization in previous literature. As most researchers believe economic variables are connected to democratization, we control for income per capita (proxied by GDP per capita), income inequality (proxied by Gini Index) and trade openness (MCMANN *et al.*, 2017; KAVASOGLU, 2022). All these variables have been shown to have a positive relationship with democracy since we expect faster-growing, higher-income and more egalitarian countries to be more democratically stable.

In addition to the aforementioned variables, we also control for human capital, given that the literature on democratic backsliding have consistently underscored the positive impacts of socioeconomic development on democracy (RØD *et al.*, 2020). We also include government consumption as a control variable (BUE *et al.*, 2021), as empirical studies have reported a positive association between democracy and the provision of public goods (*e.g.* DEACON, 2009).

Moreover, we incorporate a measure of natural resources, given that previous studies have emphasized that the dependence on natural resources may have a negative impact on democracy levels (e.g RUTH-LOVELL *et al.*, 2019). Furthermore, we control for the number of years a country has been a democracy using the Stock of Democracy variable (EDGELL *et al.*, 2020). This allows us to separate the effect of financialization levels from the effect of simply becoming more experienced with democracy.

To investigate the transmission channels through which financialization affects democracy, we estimate six additional models that can be divided in two groups, namely political factors, and economic factors. In the group of political factors, we regress the variables rule of law, clientelism, political corruption, and political polarization against financialization plus a set of controls for each model. As discussed earlier, the rule of law is expected to have a positive impact on democracy, while clientelism, political corruption, and political polarization are all expected to have a negative impact on democracy levels. The effect of financialization on the political variables is estimated through an equation of the following form:

$$pol^j_{it} = \alpha^j_i + \delta^j_t + \beta^j_1 fin_{it} + \beta^j X_{it} + \varepsilon^j_{it} \qquad (2)$$

where pol is one of the j = *{rule of law; clientelism; political corruption; political polarization}* political variables observed for country i at time t.

In the group of economic factors, we test the impact of financialization on the GDP per capita and income inequality measured by the Gini index. The relationship between GDP per capita and democracy seems to be mixed, while income inequality is expected to be inversely related to democracy. Thus, the effect of financialization on economic factors can be assessed as follows:

$$eco^h_{it} = \alpha^h_i + \delta^h_t + \beta^h_1 fin_{it} + \beta^h X_{it} + \varepsilon^h_{it} \qquad (3)$$

where eco is one of the h = *{GDP per capita, Gini index}* economic variables observed for country i at time t.

Next, we present and explore the dataset used in this work.

3.2 Data

To evaluate the connection between financialization and the recent wave of democratic backsliding, annual data were collected for a set of 49 countries spanning from 2005 to 2019. The selection of this timeframe is significant as the process of financialization has intensified after the Global Financial Crisis of 2008, while the recent erosion of democratic institutions began to unfold after 2006. Additionally, we chose not to include data from 2020 onwards to isolate the potential impacts of the SARS-CoV-2 pandemic. Unbalanced panel data were obtained considering that it was not possible to collect data for all the variables for all the years for each country. Our sample has 18 missing values, therefore being composed of a total of 717 observations.

As previously discussed, the extensive review of empirical literature on financialization has demonstrated the absence of an indicator capable of capturing the dual dimension of this phenomenon. In other words, an indicator that measures both the expansion of finance and the simultaneous contraction of the productive sector. To create an indicator that addresses this need, we initially compute the value added by the insurance and finance sector as a proportion of the total value added to the economy. These data have been previously employed in empirical studies that seek to quantify the financialization process (*e.g.* BARRADAS, 2019) and provide an accurate measure of the expansion of the financial sector in relation to the overall economy. Next, we calculate this variable in relation to productive investment, measured by the capital stock as a proportion of GDP. Hence, by computing the expansion of the financial sector in relation to productive investment, we derive an index capable of capturing the dual dimension of financialization as a macro-level phenomenon, as defined by Krippner (2005). Essentially, it allows us to quantify the rise of finance at the cost of the productive sector. The description and descriptive statistics of all the variables used are presented in Table 3.

Table 3 - Variables, description, and database

Variable	Description	Source
Financialization Index	Value added by the production of goods and services to total value added, as a share of gross capital formation to GDP.	Authors' own elaboration
Finance and insurance value	Value added by the production of goods and services in financial and insurance activities.	OECD
Total value	Value added by the production of all goods and services.	OECD
Productive investment	Share of gross capital formation to GDP.	PWT
Liberal democracy	Liberal democracy prioritizes safeguarding individual and minority rights against state/majority oppression. It ranges from 0 (not at all democratic) to 1 (fully democratic).	V-Dem
Clientelism	Clientelism involves the selective allocation of resources in return for political backing. Lower scores indicate a normatively better situation.	V-Dem
Gini Index	Income distribution inequality.	World Bank
Government consumption	Share of government consumption at current purchasing power parity (PPP).	PWT
Human Capital	Years of schooling and returns to education.	PWT
Logged GDP per capita	Logarithm GDP divided by population.	Author's own elaboration based on the PWT.
Natural resources	Total natural resource rents as a percentage of GDP.	World Bank
Political corruption	Different forms/levels of corruption within all government branches. Lower scores indicate a normatively better situation.	V-Dem
Political polarization	The degree to which political divisions impact social interactions outside of political discussions. Lower scores indicate a normatively better situation.	V-Dem
Rule of law	Multiple aspects of judicial independence.	V-Dem
Stock of Democracy	Number of years a country has been a democracy.	Authors' own elaboration based on Edgell *et al.* (2020).
Trade Openness	Exports plus imports.	Authors' own elaboration based on the PWT dataset

Source: authors' own elaboration

The financialization index encompasses 49 countries from 2005 to 2019 and it ranges from a minimum value of 0.07 to a maximum value of 0.89, as presented in Table 4. Higher values indicate a greater level of financialization, reflecting a more substantial expansion of the financial sector and a reduced level of productive investment. Conversely, lower values are associated with less financialization. Additionally, the index has a median value of 0.19 and a mean of 0.23. The 1st and 3rd quartiles are, respectively, 0.14 and 0.27.

Table 4 - Descriptive Statistics of Financialization Index

Variable	Min	1st Quartile	Median	Mean	3rd Quartile	Max
Financialization Index	0.07	0.14	0.19	0.23	0.27	0.89

Source: authors' own elaboration

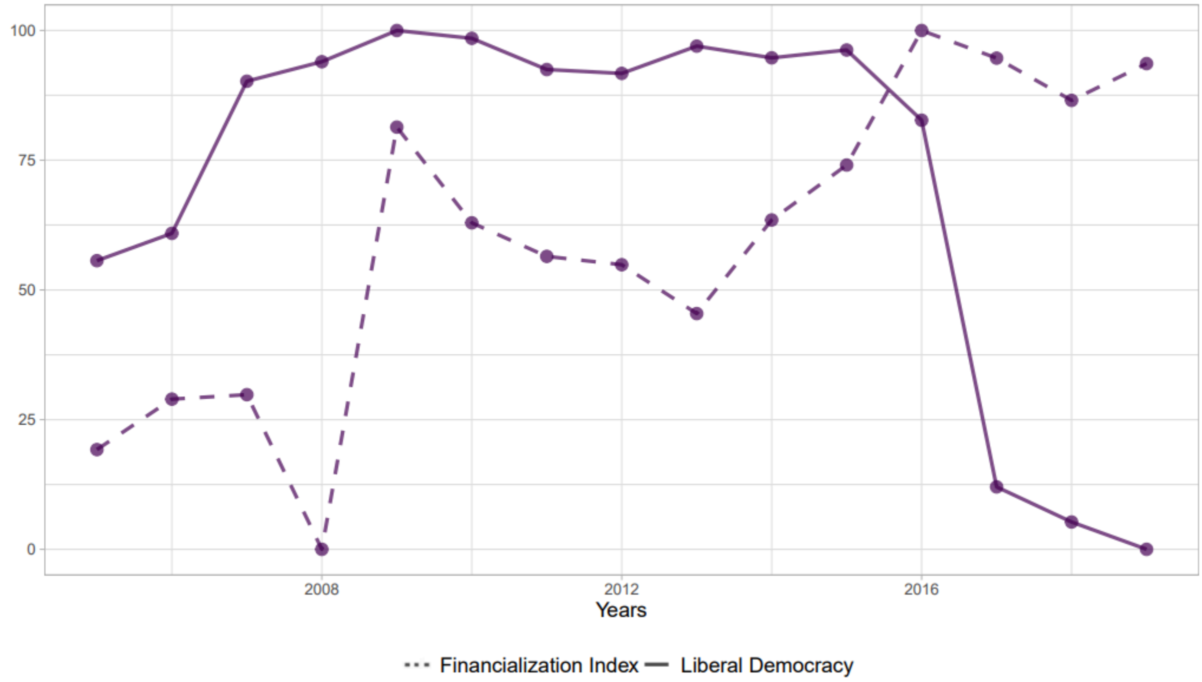
When assessing the index, it is intriguing to observe how financialization has developed in different countries and its relation to democracy levels, taking into account the political-economic particularities of each region. In the emblematic case of the United States, the epicenter of global financial capitalism since the 1970s, financialization has steadily progressed, especially following the 2008 Global Financial Crisis. Conversely, levels of liberal democracy have plateaued since that period and notably declined after 2015, as illustrated in Figure 3.

The correlation between financialization and democracy is not limited to developed economies but it is also evident in countries like Brazil and Cameroon. In both nations, the rise in financialization appears to be accompanied by a decline in democratic indicators, as depicted in Figures 4 and 5. Interestingly, the reverse trend can be noted as well, meaning that an economy may experience reduced financialization while the country undergoes increased democratization. Switzerland serves as an illustrative case of this phenomenon, as shown in Figure 6. In all these scenarios, however, the initial data analysis suggests the existence of an inverse relationship between financialization and democracy. Graphs illustrating the financialization and liberal democracy levels for all countries in our dataset are presented in Figure A1 in the Appendix.

The development of a financialization index aims to bridge a gap uncovered by the extensive literature on financialization. As aforementioned, many empirical studies use proxies to measure the expansion of finance, such as foreign assets and liabilities to GDP (STOCKHAMMER, 2009). However, these measures seem unable to relate the rise of finance to the simultaneous decrease in production levels, thus capturing only one aspect of financialization. In this regard, the index proposed in this study aims to capture the double dimension of this process by quantifying both the expansion of the financial sector and the reduction of productive investment. Therefore, we seek to obtain a more accurate measurement of financialization as a macro-level phenomenon - an approach that can be widely applied in the development of further empirical investigations.

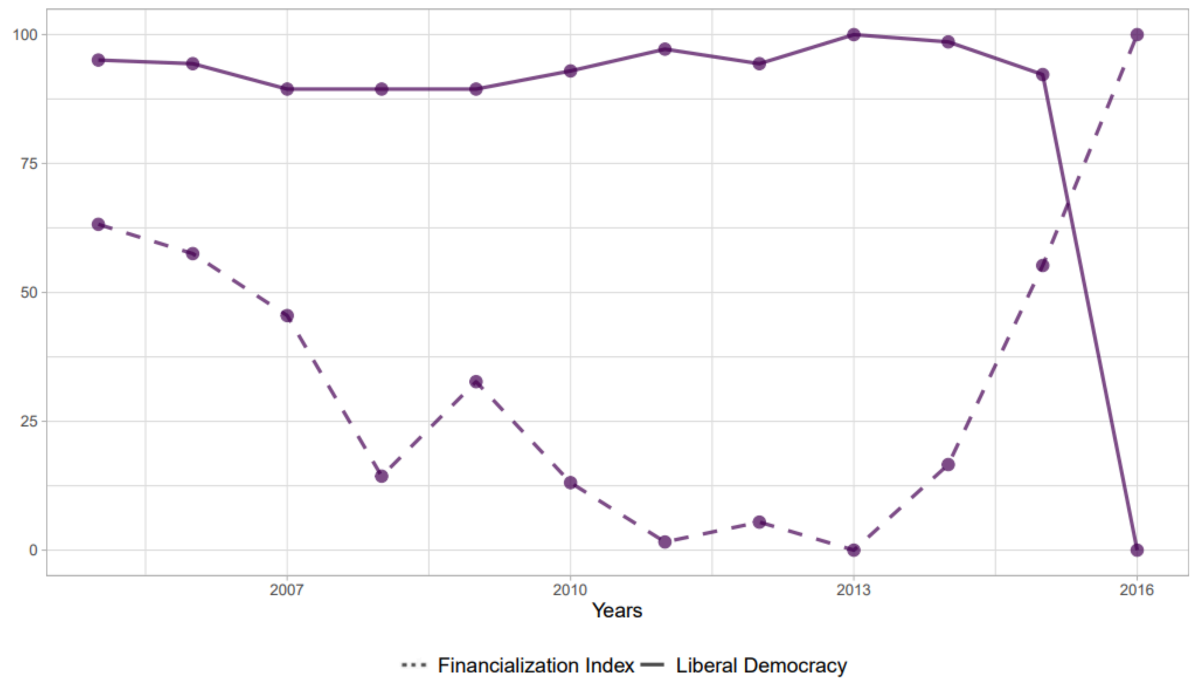
In addition to proposing a novel measure of financialization, our study also seeks to contribute to the political economy literature by making the first empirical attempt to measure the direct and indirect impacts of financialization on democratic backsliding. An extensive review of this literature reveals that no study has yet attempted to empirically assess the relationship between both phenomena, despite strong theoretical evidence underscoring the relevance of this investigation.

Figure 3 - Financialization and liberal democracy in the U.S.A. (2005 - 2019)



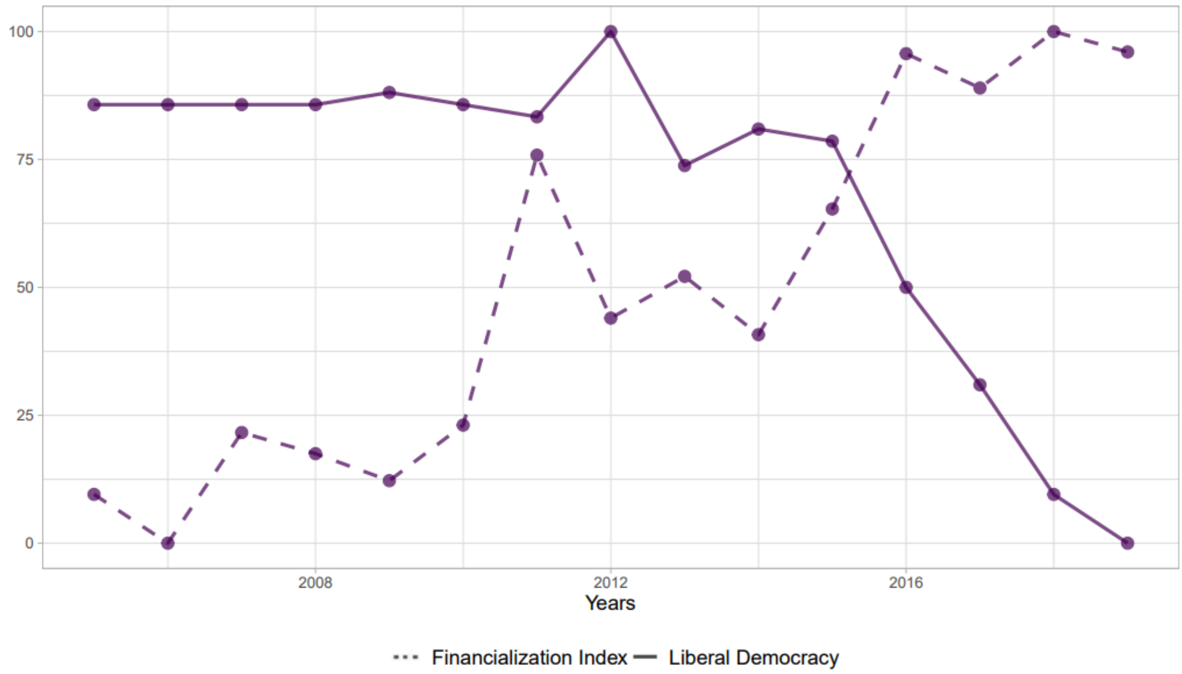
Source: authors' own elaboration

Figure 4 - Financialization and liberal democracy in Brazil (2005 - 2016)



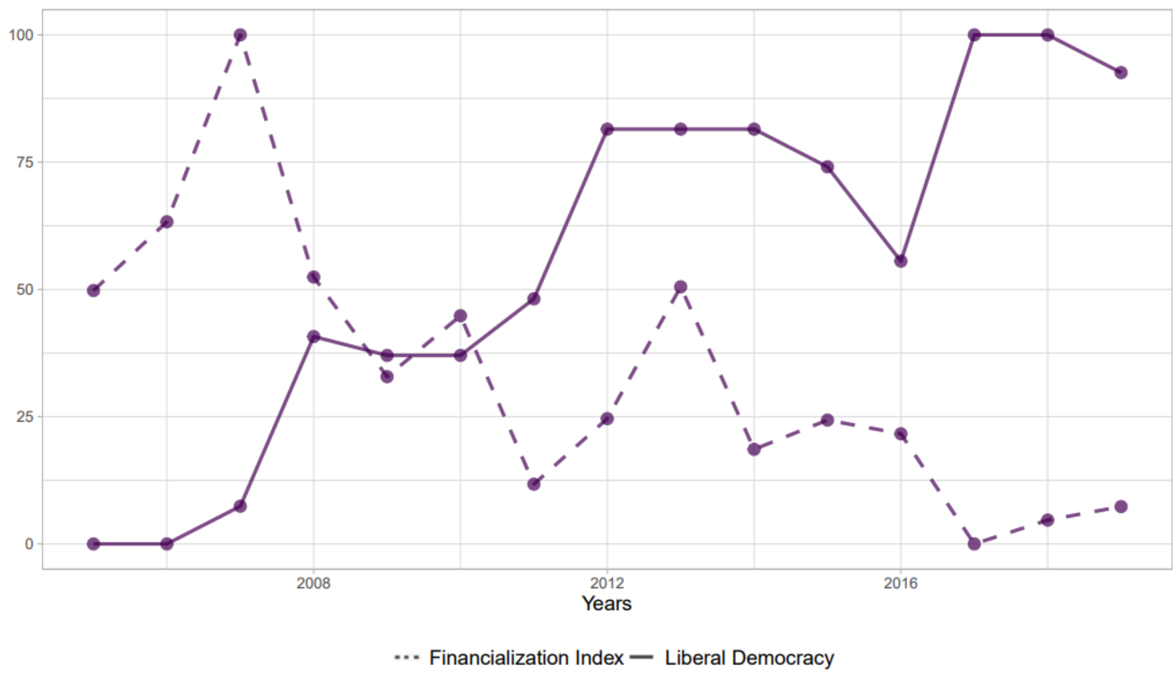
Source: authors' own elaboration

Figure 5 - Financialization and liberal democracy in Cameroon (2005 - 2019)



Source: authors' own elaboration

Figure 6 - Financialization and liberal democracy in Switzerland (2005 - 2019)



Source: authors' own elaboration

4. Results and discussion

4.1 General Model

In this section, we present our estimates and discuss the results.

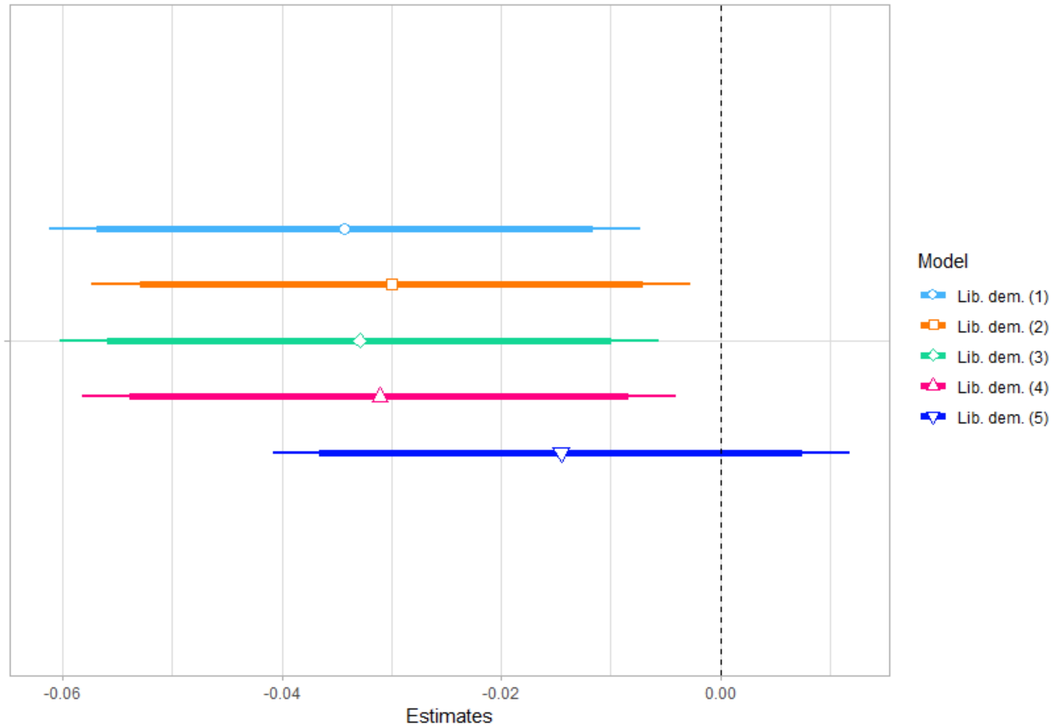
Table 5 - Determinants of liberal democracy

	Dependent variable:				
	Liberal Democracy				
	(1)	(2)	(3)	(4)	(5)
Financialization	-0.034**	-0.030**	-0.033**	-0.031**	-0.015
	(0.014)	(0.014)	(0.014)	(0.014)	(0.013)
GDP per capita	-0.0003	-0.0003	-0.0003	-0.0003	-0.0005
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
GDP per capita, lagged	-0.00003	-0.0001	-0.0001	-0.00005	0.0005
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Gini index	-0.001	-0.001	-0.0005	-0.0002	-0.0005
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Gini index, lagged	0.002**	0.002**	0.002**	0.002**	0.001**
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Human capital	-0.006	-0.003	-0.002	-0.001	-0.005
	(0.016)	(0.017)	(0.016)	(0.016)	(0.016)
Trade openness	0.001	0.001	0.001	-0.0005	-0.003
	(0.006)	(0.006)	(0.006)	(0.006)	(0.006)
Gov. consumption (% GDP)	-0.024	-0.031	-0.018	-0.008	-0.011
	(0.053)	(0.053)	(0.053)	(0.052)	(0.050)
Natural resources	0.001	0.002	0.002	0.002	0.001
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Stock of democracy	0.583***	0.579***	0.560***	0.545***	0.522***
	(0.009)	(0.010)	(0.013)	(0.014)	(0.014)
Rule of law		0.009*	0.009*	0.010**	0.008
		(0.005)	(0.005)	(0.005)	(0.005)
Clientelism			-0.065**	-0.033	-0.031
			(0.031)	(0.032)	(0.031)
Political corruption				-0.075***	-0.049**
				(0.024)	(0.024)
Political polarization					-0.012***
					(0.002)
Observations	516	516	516	516	516
Adjusted R^2	0.892	0.893	0.893	0.895	0.905

Note: *p < 0.1; **p < 0.5; ***p<0.01.
Source: authors' own elaboration.

Our findings indicate that financialization, proxied by the financialization index, has a significant and negative impact on levels of liberal democracy in 4 out of 5 models tested, as shown in Table 5 and illustrated in Figure 7.

Figure 7 - Estimated response of liberal democracy to changes in the financialization index



Source: authors' own elaboration

While these results should be interpreted with prudence, we contend that our estimates are generally consistent with Proposition 1, delineated in Section 2.3. This proposition posits that financialization exerts a direct and adverse effect on democratic levels.

When considering the political variables introduced in each of the models, the rule of law exhibits the expected positive and significant impact on democracy in models 2, 3, and 4. Clientelism is consistently negative across all models, as anticipated; however, it is only significant in model 3. Political corruption demonstrates a negative and significant impact on democracy in all models where it is estimated, as expected. Finally, political polarization also shows a negative and significant effect on democracy in model 5, in accordance with our initial assumptions.

Regarding the economic variables, current and lagged observations of the GDP per capita do not yield statistically significant results in any of the estimates. Conversely, the lagged observations of the Gini Index exhibit a significant impact on liberal democracy. However, this impact is positive, contrary to our initial expectations. Nonetheless, this result should be interpreted with caution. While most scholars argue that higher income inequality is associated with lower levels of democracy, empirical evidence is ambiguous, as briefly discussed in our Proposition 7.

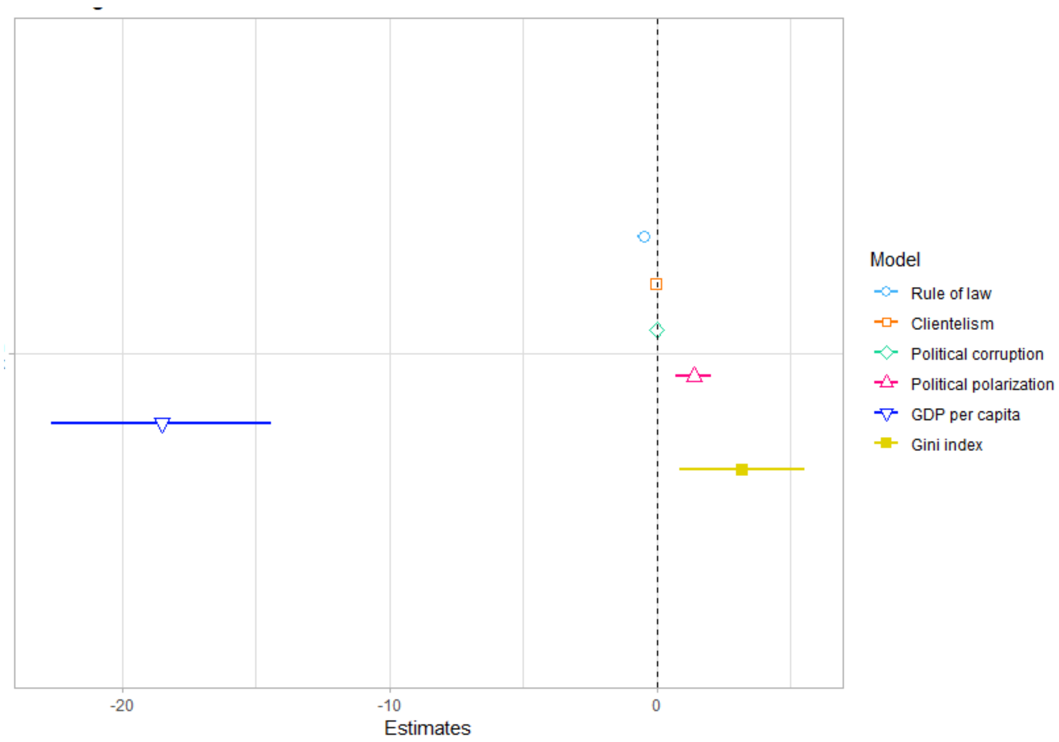
In short, after controlling for various socioeconomic and political determinants of democracy, our findings strongly indicate that increases in financialization may directly contribute to democratic backsliding. Furthermore, we conclude that liberal democracy is also impacted by the stock of democracy, rule of law, political corruption, political polarization, and income inequality.

4.2 Links Between Financialization and Democratic Backsliding

In addition to evaluating the direct impact of financialization on democracy, we also examined the effect of the financialization index on other political and economic variables. The key findings are depicted in Figure 9 and elaborated upon below. The coefficients of these estimates are provided in Tables A1 and A2 in the Appendix.

Firstly, the results indicate that the financialization index has a negative and significant impact on both rule of law and clientelism, aligning with our initial assumptions set forth in Propositions 2 e 3, respectively. However, contrary to our expectations advanced in Proposition 4, the estimates did not reveal a statistically significant impact of financialization on political corruption. It is conceivable that this outcome is linked to the process of financialization of the state, which gradually promotes the replacement of government sectors by market agents. Ultimately, this might decrease political corruption as fewer institutions fall under public governance (AALBERS, 2019). However, it is worth noting that the extensive body of literature on the relationship between corruption and democracy allows for a wide range of interpretations.[4] Finally, our estimates also revealed that financialization has a significant and positive impact on political polarization, in accordance with Proposition 5.

Figure 8 - Estimated response of political and economic factors to changes in the financialization index



Source: authors' own elaboration

Regarding the economic variables, financialization has a significant impact on both GDP per capita and the Gini Index, which are proxies for domestic income and income

[4] For a more comprehensive debate on the relationship between corruption and democracy, see Drapalova (2019).

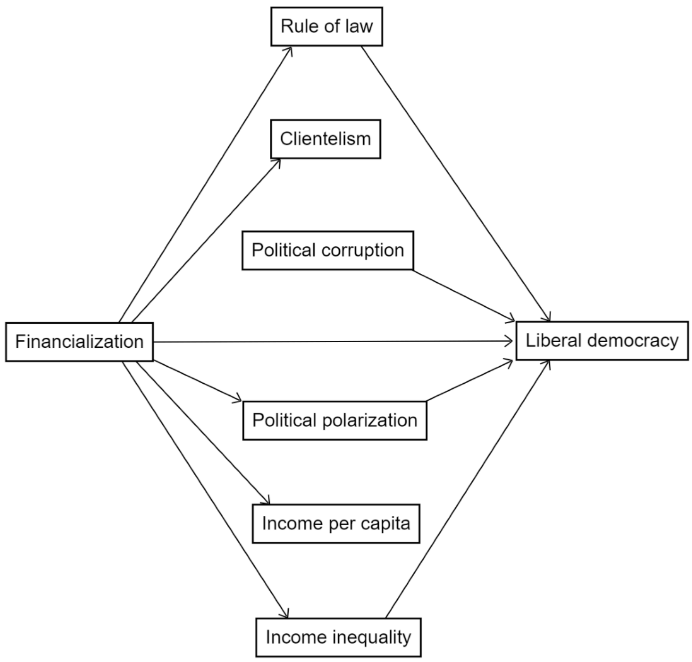
inequality, respectively. However, in the case of GDP per capita, these impacts are negative, while the impacts on the Gini Index are positive. These estimates exhibit the expected directionality and are consistent with our previous discussions in Propositions 6 and 7, respectively.

In summary, our findings indicate that financialization affects other political variables beyond liberal democracy. Specifically, rule of law, clientelism, political polarization, income per capita, and income inequality are all shown to be impacted by financialization. Next, we aim to discuss how these results contribute to our understanding of the relationship between financialization and democracy.

4.3 Discussing the results

Our empirical analysis reveals important findings. Firstly, the financialization index proposed in our study appears to be a valid and accurate tool for mapping out the financialization process at the country level. Furthermore, our results indicate that liberal democracy is influenced by financialization, political corruption, political polarization, rule of law, and income inequality. Conversely, financialization impacts the rule of law, clientelism, political polarization, income per capita, and income inequality. Building upon these findings, we reassess our initial propositions and determine which ones hold true following the conclusion of our empirical study. In light of these results, Figure 2 can be redefined and re-presented along the lines of Figure 9 below.

Figure 9 - Transmission channels through which financialization impacts liberal democracy



Source: authors' own elaboration

Our findings indicate that financialization directly undermines democracy, in accordance with Proposition 1. Additionally, financialization negatively impacts democratic institutions through the rule of law, which acts as a primary transmission channel, as discussed in Proposition 2. Regarding clientelism, we found that this variable does not affect democracy, despite being influenced by financialization. Thus, Proposition 3 is not upheld.

Similarly, Proposition 4 is not supported by our results, given that financialization does not impact political corruption, although corruption negatively affects democratic indices. Furthermore, political polarization is revealed to be a second transmission channel through which financialization detrimentally affects liberal democracy, as posited in Proposition 5.

Regarding the economic transmission channels, we found that income per capita is negatively impacted by financialization; however, income itself does not significantly affect democratic institutions. Thus, Proposition 6 is not supported by our estimates. Finally, income inequality is revealed to be the third and final transmission channel through which financialization undermines liberal democracy, as discussed in Proposition 7. However, it is worth noting that increasing income inequality is shown to yield a positive effect on democratic indices. Nevertheless, it is crucial to approach these findings with caution. Although much of the theoretical literature argues that higher income inequality is associated with lower levels of democracy, empirical evidence is ambiguous (CHISADZA & BITTENCOURT, 2019).

5. Conclusion

The recent wave of democratic backsliding has puzzled researchers for the past decade, especially regarding the economic factors associated with this process. Conversely, the phenomenon of financialization has been widely studied since the 1980s, but its effects on democracy had not been empirically tested to this date. Therefore, our study aims to bridge a gap in the political economy literature by assessing the relationship between financialization and democratic backsliding for a sample of 49 countries between the period of 2005 and 2019. Additionally, we contribute to the existing empirical framework by proposing a novel financialization index to measure the expansion of finance at the expense of the productive sector.

In conclusion, the empirical findings presented in this study provide some evidence that financialization may play a crucial role in shaping political transformations witnessed in the 21st century. Hence, this study sheds light on the importance of government actions aimed at reducing the degree of financialization in our economies. Despite the various financial reforms implemented after the Global Financial Crisis, these measures alone seem to have failed to halt the advance of financialization. To curb the deepening of the financialization process, some critical measures could be implemented such as stronger public policies and regulations to enhance capital control. This may include controlling cross-border capital flows, raising financial transaction taxes, and downsizing banks and other financial institutions.

Furthermore, exploring the economic and political repercussions of financialization involves considering other pertinent variables, such as unemployment and political stability. Therefore, future research should investigate other possible mechanisms through which financialization may affect politics and economics. They may also explore alternative econometric methods and control variables to test these results. Finally, other potential improvements and extensions of the present study may include examining the effects of financialization in various groups of countries by different aspects such as the level of income and socioeconomic profiles.

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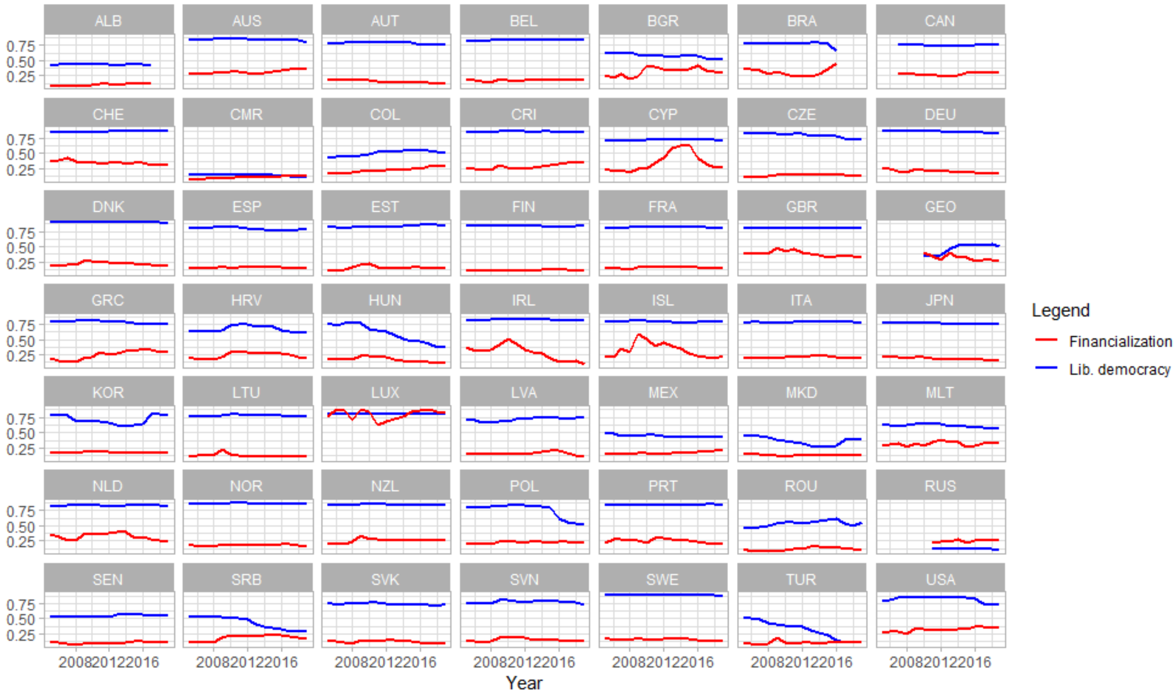
APPENDIX

Figure A1 - Financialization index and liberal democracy by country



Source: authors' own elaboration

Table A1 - Estimated response of political factors to changes in the financialization index

	Dependent variable:			
	Rule of law	Clientelism	Political corruption	Political polarization
Financialization	-0.488***	-0.051**	-0.008	1.367***
	(0.126)	(0.021)	(0.029)	(0.334)
GDP per capita	0.004	-0.0004	0.001	-0.017
	(0.006)	(0.001)	(0.001)	(0.016)
GDP per capita, lagged	0.004	-0.0002	0.001	0.045***
	(0.006)	(0.001)	(0.001)	(0.016)
Gini index	0.005	0.003***	0.005***	-0.008
	(0.006)	(0.001)	(0.001)	(0.017)
Gini index, lagged	-0.011**	-0.001	-0.001	-0.012
	(0.006)	(0.001)	(0.001)	(0.015)
Trade openness	0.064	-0.001	-0.016	-0.191
	(0.051)	(0.008)	(0.012)	(0.136)
Gov. consumption (% GDP)	0.973**	0.206***	0.243**	0.632
	(0.440)	(0.073)	(0.100)	(1.169)
Stock of democracy	0.519***	-0.285***	-0.280***	-2.422***
	(0.078)	(0.013)	(0.018)	(0.206)
Observations	535	535	535	535
Adjusted R^2	0.063	0.480	0.324	0.176

Note: $^{*}p < 0.1$; $^{**}p < 0.5$; $^{***}p<0.01$.
Source: authors' own elaboration.

Table A2 - Estimated response of economic factors to changes in the financialization index

	Dependent variable:	
	GDP per capita	Gini index
Financialization	-18.517***	3.177***
	(2.100)	(1.198)
Gini index	0.025	
	(0.112)	
Gini index, lagged	-0.176	
	(0.107)	
GDP per capita		-0.111**
		(0.054)
GDP per capita, lagged		0.087
		(0.056)
Trade openness	-3.538***	-2.435***
	(0.939)	(0.481)
Human capital	-6.408**	-6.556***
	(2.652)	(1.334)
Gov. consumption (% GDP)	-64.761***	-11.159***
	(7.989)	(4.279)
Natural resources	-0.128	0.095
	(0.168)	(0.080)
Rule of law	1.863**	-0.363
	(0.802)	(0.423)
Stock of democracy		0.403
		(1.137)
Clientelism		6.256***
		(2.375)
Political corruption		8.583***
		(1.954)
Political polarization		-0.285*
		(0.160)
Observations	516	551
Adjusted R^2	0.239	0.085

Note: $^{*}p < 0.1$; $^{**}p < 0.5$; $^{***}p<0.01$.
Source: authors' own elaboration.