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Financial sector policies and income inequality☆

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ABSTRACT

While finance has been shown to influence the distribution of income, little research has been devoted to the potential impact of financial policy on income inequality. This study analyzes the relationship between repressive financial policies and inequality across countries. We show that financial repression tends to increase income inequality. Robustness checks using GMM estimation and the modeling average method confirm the positive relationship between financial repression and income inequality. We also find that credit controls and entry barriers in banking sector are the two most important financial policies influencing inequality. Moreover, GDP per capita growth and urbanization serve as two important factors that might alleviate income inequality. These results have important policy implications, not the least so for quickly developing countries such as China, where rising inequality possesses a significant problem.

1. Introduction

The levels of inequality vary significantly across countries and regions. The Human Development Report in 2011 also shows that overall inequality has worsened. Furthermore, the distribution of income varies significantly over time. While some countries undergo considerable declines in inequality, others experience increases (e.g. Beck, Demirguc-Kunt, & Levine, 2007). These patterns suggest that the understanding of what drives inequality is as important as ever.

There is a growing literature on finance and inequality that primarily focuses on the potential effects of financial development in inequality. As Demirguc-Kunt and Levine (2009) point out, a less developed financial system may influence how important individual skills versus parental wealth, social status and political connections are for an individual's economic opportunities. A poorly developed financial system may therefore increase the persistence of the gap between the rich and poor. In addition, financial development or the general quality of a financial system may affect capital allocation, which in turn has an effect not only on economic growth in general, but also on the demand for labor across sectors, thus influencing income levels for different parts of society. A number of studies have linked finance to inequality with analyses based on arguments like these.

However, while the link between finance and inequality is now commonly acknowledged, much less research has gone into trying to identify potential relationships between financial policies and inequality. Demirguc-Kunt and Levine (2009) note that

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there is "startlingly little research on how formal financial sector policies – such as bank regulations or securities markets laws – affect inequality". Using a comprehensive cross-country panel data set, this study attempts to shed light on the potential link between financial policies and inequality. In particular, we focus on how repressive financial policies affect the level of income inequality across countries. Our empirical analysis supports the hypothesis that repressive financial policies increase inequality. In addition to initial fixed effect regressions, we also take potential endogeneity issues into consideration by performing robustness checks with instrumental variable (IV) regressions and the modeling average method. Finally, we identify several individual policies including interest rate controls, capital account controls, weak banking supervision, and concentration in the banking sector that are especially important for inequality. We believe that these results are of particular importance to policymakers in low- and middle-income countries that exhibit high and, in some cases, increasing levels of inequality.

The rest of this study is structured as follows. In the next section, we frame the topic of financial repression and inequality with two strands of literature, one that links finance in general to inequality and one that focuses on financial repression. Section 3 introduces the data and then discusses the empirical methodology. Section 4 presents the results from the baseline regression model as well as the effects of individual policies on income inequality across countries. Section 5 provides robustness checks of the empirical results from the baseline estimation. Section 6 then discusses the case of China. Finally, Section 7 concludes the study.

2. Literature review and theoretical framework

The importance of finance is not new to the literature on inequality. Finance is often incorporated in theoretical models in the form of exogenous financial market imperfections that lead to income inequality. For example, Mookherjee and Ray (2002) note that credit markets must be assumed missing or imperfect in dynastic models, otherwise finances necessary for offspring to further their education may be borrowed, leading to equalization of wages (net of costs) across professions. Becker and Tomes (1986) employ the often used argument that human capital functions as poor collateral to lenders due to the risk of moral hazard to incorporate imperfect access to capital in their model on transmission of earnings, assets and consumption (and thus inequality) across generations. Galor and Zeira (1993) show that, in the presence of credit market imperfections, countries with different wealth distributions that invest in human capital can follow very different growth paths. Banerjee and Newman (1993) model economic development by focusing on occupation decisions. They demonstrate that poor agents choose to work for a wage over self-employment due to capital market imperfections. In their dynastic model, Mookherjee and Ray (2003) demonstrate how imperfect capital markets result in persistent inequality. Matsuyama (2004) incorporates credit market imperfections in an overlapping-generations model to analyze financial market globalization and the inequality of nations.

As noted earlier, capital market imperfections can have particularly severe consequences for the underprivileged as such imperfections limit their economic opportunities. A relaxation of credit constraints can thus reduce inequality and allow for a more efficient credit allocation. However, it has also been argued that financial development may actually increase the level of inequality, as improved financial services may favor those who are already using them the most (Greenwood & Jovanovic, 1990). Clarke, Xu, and Zou (2006) show that financial development does reduce inequality and therefore reject the argument that financial development favors the rich. Similarly, Beck et al. (2007) provide evidence that financial development increases income for the poorest more than for wealthier income groups, thereby reducing overall inequality. They also find that financial development brings with it a significant drop in the fraction of the population that lives on less than $1 day, thus emphasizing the importance of financial development for the poorest.

While the studies above are important for the understanding of the relationship between finance and inequality, they do not analyze financial policy. Demirguc-Kunt and Levine (2009) argue that economists tend to underestimate the potentially important impact of financial sector policies on inequality. This paper is, to the best of our knowledge, the first study that focuses on how repressive financial policies may affect inequality. McKinnon (1973) was arguably the first to use the term financial repression. He defined it as financial policies set by the government for the purpose of regulating interest rates, setting reserve requirements on bank deposits, and allocating resources in the economy. Such repressive policies are commonly believed to be hindering financial deepening, lowering the efficiency in the financial system and, as a result, holding back economic growth (McKinnon, 1973; Shaw, 1973). Roubini and Sala-i-Martin (1992) develop a theoretical model that incorporates the negative effect of financial repression on growth and then show empirically that this indeed seems to be the case for a large panel of countries. In a related paper, King and Levine (1993) present a model in which financial sector distortions have a negative impact on the rate of innovation, which in turn leads to lower overall economic growth.

We argue that repressive financial policies have the potential to greatly increase the level of inequality. Linking the literature on financial development and inequality with that on financial repression, previous research shows that financial repression may hinder financial development. For example, King and Levine (1993) find that financial repression can have a negative effect on financial development. In a related paper, Ang and McKibbin (2007) show that repressive financial policies have a significant negative effect on financial deepening. When implementing repressive and distortive financial policies, the government is in effect allocating financial resources to certain sectors in the economy. In line with this reasoning, Johansson and Wang (2011) develop a model in which financial repression distorts the economic structure in favor of the industry sector. In a related study, Johansson and Wang (2012) find that severe repressive financial policies lead to external imbalances, most likely a result of a distorted economic structure due to the emphasis on allocation of capital into the domestic manufacturing sector. The allocation of capital into selected economic activities may in turn reduce the efficiency in the financial sector and limit economic opportunity.

Based on the previous discussions on lower efficiency and limited economic opportunity due to credit constraints for the poor, repressive financial policies can thus be expected to increase the level of inequality. For example, regulated interest rates may