

International evidence on how income inequality and credit market imperfections affect private saving rates[☆]

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Abstract

This paper empirically examines the hypothesis that income distribution exerts an independent effect on private saving rates across countries, and tests particular channels for income inequality to affect private saving rates. Cross-sectional and panel regression results show that inequality has a robust, positive effect on private saving rates that depends on financial market development and credit available to the private sector. The paper, thus, identifies credit market imperfections as the likely reason for the inequality–private saving link. The data provide no evidence supporting a subsistence channel for inequality to affect private saving as suggested by nonhomothetic utility functions. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

This paper empirically examines the hypothesis that income distribution exerts an independent effect on private saving rates in the cross-country data. This research is motivated by the lack of a clear-cut relationship between saving rates, income inequality, and growth rates in the macroeconomics and development literature. The distribution of income has recently received much theoretical and empirical attention as some papers estimated a negative, reduced-form effect of income inequality on investment and growth rates (Alesina and Perotti, 1996; Alesina and Rodrik, 1994; Perotti, 1996). These results coincide with the East Asian “miracle” countries, which achieved high growth rates with high saving rates and low levels of initial inequality relative to other countries at similar income levels. A standard prediction of growth models is that higher saving is necessary for higher growth, either temporarily in the transition to a new steady state in the Solow model or permanently in endogenous growth models. This relationship between saving and growth implies an a priori negative correlation between income inequality and saving rates if in fact inequality reduces growth (and investment) rates.¹

A puzzle exists because of the strong tradition in the development literature that income inequality has a positive effect on saving rates and growth (Lewis, 1954; Kaldor, 1957).² Recent empirical evidence has supported this view, as Cook (1995) estimated a positive effect of inequality on saving rates in developing countries, and Forbes (1997) found a positive effect of inequality on growth in an industrial and developing country sample. In practice, saving, investment, and growth rates are highly correlated in the data, but the direction of causality is unclear and simultaneity is likely — the so-called “virtuous circle” between saving and growth.

Despite these conflicting predictions and a wealth of theoretical models, relatively little empirical work has been done on income distribution and saving. This is largely the result of two issues. The first is the lack of consistently defined and internationally comparable time-series data on income distribution for a cross-section of countries. The second is theoretical ambiguity about how the distribution of income affects saving rates.³ Measurement problems and interna-

¹ In a closed economy, saving is investment so saving and inequality are negatively correlated if inequality lowers investment and growth. In an open economy with perfect capital mobility, national saving and domestic investment can be uncorrelated (Feldstein and Horioka, 1980).

² Kaldor (1957) focused on the functional distribution of income, i.e., the share of national income that accrues to factors of production. This paper used the size distribution of income, i.e., the share of national income accruing to different percentiles of the populations.

³ In Keynes (1936), saving rates increased with income, while Friedman (1957) argued that high and low income groups save the same fraction of permanent income. Lucas (1976) and Hall (1978) shifted consumption research away from levels in favor of first differences.

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