Emerging Markets Review 11 (2010) 404–408

Contents lists available at ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Availability of financial services and income inequality: The evidence from many countries

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ARTICLE INFO

Article history:
Received 28 January 2010
Received in revised form 19 June 2010
Accepted 15 July 2010
Available online 23 July 2010

JEL classification:
F3
F4
G2

Keywords:
Financial services
Macro-finance
Income inequality
Banking

ABSTRACT

Using a sample of developed and developing countries this study empirically gauges the impact of the availability of financial services, as measured by the number of bank branches per 100,000 populations on income inequality. The results show that greater access to bank branches robustly reduces income inequality across countries. The study also documents that barriers to bank access significantly increases income inequality.

1. Introduction

While a voluminous extant literature has documented a strong link from financial development to economic growth, as summarized in Levine (1997 and 2005), a relatively small group of recent studies have explored the important nexus between financial development and income inequality (Levine (2007); Beck, Kunt and Levine (2007); and Clark, Xu and Zou (2006)).

All of these studies clearly document a statistically significant improvement in income inequality, as measured by a country's Gini coefficient and aggregate measure of financial development, typically proxied by some aggregate measure of financial development such as credit to the private sector by financial intermediaries, usually referred to as 'private credit'.

This has led to a growing policy consensus that financial development can benefit the poor (Rajan and Zingales (2003); Levine (2007) and Akhter and Daly (2009)).

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1566-0141/$ – see front matter
doi:10.1016/j.ememar.2010.07.001

The importance of financial development in mitigating income inequality can be traced to the earlier theoretical works of Galor and Zeira (1993) and Banerjee and Newman (1993). Both set of papers show a negative relationship between financial sector development and income inequality in the face of lumpy investment and imperfections in the financial sector. However Greenwood and Jovanovic (1990) argue for a more complicated non-linear (inverted u-shaped) relationship between financial development and income inequality. They show that initially the rich benefit from financial development, but, over time as more people have access to the financial system income inequality declines.[1] More recent work by Classens and Perotti (2007) and the World Bank (2007) provide a more detailed and nuanced discussion of the important embedded role of finance and specifically access to finance and its effects in mitigating income inequality in the process of development.

Empirical evidence on the role of financial access in mitigating income inequality is however limited (World Bank, 2007). As a result, and unlike earlier studies, we employ a more micro focused measure as a proxy for financial development and access to financial services, which better captures how financial development potentially impacts income inequality. This measure is discussed in more detail in the next section.

Based on the above discussion this paper attempts to empirically gauge the relationship between financial development and income inequality for a sample of developing and developed countries. Section 2 presents a short discussion of the extant theoretical and burgeoning empirical literature on the relationship between financial access and inequality. Section 3 discusses the data and the model(s) to be estimated. Section 4 contains a discussion of the empirical results. Finally, Section 5 contains some concluding remarks.

2. Finance and inequality

The vast majority of the extant literature on finance and growth has focused on the size of the financial sector and its impact on growth and inequality, a relatively macro perspective. This literature is usefully summarized by Levine (2005). Only recently has a smaller subset of this literature focused on the link between financial access – a more micro perspective – and its effects on inequality. That access to financial services is still very uneven, especially in developing and emerging economies is now well documented (World Bank, 2007). This state of affairs in turn was hypothesized to be caused by elite established interests, who having greater access to political power, attempt to protect their rents by limiting access to finance which in turn reduce entry and competition (Perotti and Volpin, 2007). Thus any improvements in financial access, and the concomitant reduction in credit constraints, is expected to disproportionately benefit the poor by facilitating funding to the less well off and their productive investments (Galor and Zeira, 1993; and Galor and Moav, 2004). This in turn is expected to reduce inequality.

As noted earlier the empirical literature in this area is rather sparse. An early study of the impact of bank branches in rural India on poverty and output found that both poverty and output increased with greater access to finance (Burgess and Pande, 2005). Beck et al. (2008) also found that greater access to bank branches in the US lowered income inequality. Other studies, Honahan (2004) and Clarke et al. (2006) use more macro focused indicators of financial development and show that financial development does indeed reduce poverty and income inequality. But no studies have explored the link between access to finance and income inequality across a broad range of countries. Based on the above discussion the next section discusses the data and model employed in this paper to explore the relationship between access to finance and income inequality.

3. Data and model

3.1. Data

To measure the degree of income inequality this study uses Gini coefficient data from the UN-Wider data set, for seventy developing and developed countries. Because the study uses cross sectional analysis, the Gini coefficient data for each country is the average over the period 2000–2005.[2]

[1] There is no robust support for this in the extant empirical literature. See Clarke et al. (2006).
[2] To maximize the sample size, we did not use other measures of income inequality or poverty.