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Finance, governance and inequality: A non parametric approach

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ABSTRACT

The aim of this paper is to examine the multi-faceted relationship between financial development, governance and inequality. Using data for 39 countries during 1996-2009, the construction of composite indicators shows that Latin American & Caribbean countries present a less developed governance and financial system than European & North American countries. Non-parametric correlations tests show that these dimensions are significantly and positively correlated. The financial system development requires good governance. PCA suggests that governance improvement would lead to equal income distribution. Good governance should be pursued as a basic development goal especially for the Latin America & the Caribbean region. To maximize its effect, the context-specific nature of the linkages between governance and financial development must be recognized.

1. Introduction

Over the years, income inequality has widened. Firebaugh [10] cites numerous statements about the growing inequality in average income between countries made by the World Bank, IMF, UNDP and WTO. From 1950 to 1973, the countries of Western Europe, the United States and Japan had growth rates higher than China, India and the USSR. From 1973 to 1990, China goes far beyond these countries but India has the same performance and the USSR lags behind. However, 1990 marked a break: from that date many emerging countries[1] have better performance than the "rich" countries. From 1990 to 2003, China and India go far

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[1] Emerging countries are broadly defined as nations with social or business activity in the process of rapid growth and industrialization. In other words, the term “Emerging country” is used to indicate an intermediate stage between a developing nation, which often lacks significant industrialization, and a developed nation, which usually has a high Gross Domestic Product and a high level of industrialization. Often times, this nation is in the process of moving from a closed economy to an open market economy.

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beyond all of them since 2003 and the gap continues to widen. Many poor countries, particularly Africa, are experiencing stagnation so that the income gap increases.

Further, in recent years, financial development is characterized by an unprecedented progress over the world. Most countries have embarked on an overall economic reform package that included policy and structural reforms in the financial sector. The essentiality of good governance also has been a key focus in development policy discussions. As a result, several authors claim that income inequality can be related to either financial development or governance. At the best of our knowledge, the complementary effects of financial development and governance in influencing income inequality are rarely discussed and there is not much progress in this area. We may say that there is no clear quantitative lesson to be drawn from the existing literature. Thus, this paper attempts to fill this gap by exploring the multi-faceted relationship between financial development, governance and inequality. The first object is to construct composite indices of governance and financial development. The second object is to establish whether there are significant correlations between financial development, governance and inequality. Our aim questions are:

Do economies with governance in surplus have higher financial development?

Do economies with governance in surplus have lower income inequality than those with governance in deficit?

Do economies with higher financial development have lower income inequality than those with lower financial development?

In the next section, we present a review of several existing research. Section III describes the dataset and the methodology. We propose in section IV an empirical analysis through a non-parametric approach Data Envelopment Analysis, Spearman's and Kendall's non parametric rank correlation tests and PCA approaches. Section V concludes and draws implications for sustainable economic policies.

2. Existing literature

Over the years, income inequality has widened. Among the causes of this phenomenon, there are financial development and governance. The review of the existing literature reveals that financial development, governance and income inequality are frequently studied separately without investigating their interdependence. On one hand, a body of literature indicates that the distribution of incomes and the financial development are obviously related. With all else remaining equal, Banerjee and Newman [2] and Galor and Zeira [11] suggest that there is a linear correlation between financial development and income inequality. Financial market imperfections - such as the exorbitant costs of transactions and contract enforcement - contribute to restricted access to development in the poor countries that lack collateral and contacts. Thus, even when the poor can have projects with high expected returns, it might be difficult to obtain the necessary levels of funding. This might reduce the efficiency of capital allocation and limits social mobility of the poor. In such circumstances, income inequality rises with the development of financial markets even in long-term. Greenwood and Jovanovic's [12] model predicts that different mechanisms might dominate at different levels of financial sector development, leading to a nonlinear relationship between financial sector development and inequality. The economists show how financial and economic development might give rise to an inverted U-shaped relationship between income inequality and financial sector development. It is hypothesized that income inequality first increases with the degree of sophistication in the financial systems, then stabilizes and eventually declines in long-term as more people join financial coalitions. However, little empirical studies have been undertaken so far and do not provide a clear-cut prediction on the sign of the relationship across financial development and income inequality. These researches have focused on single indicators of financial development and have not considered a composite indicator. Li et al. [19] found a positive influence of financial development, but their study is marred by a number of technical failures. Bulíř [8] investigated the effect of inflation on income differences. The ratio of financial deepening - included as control variables - has a positive and significant impact with low amplitude. The results of both cross-country and panel data regressions suggest that inequality is reduced not only through enhanced loan markets, but also through more developed stock markets (Kappel [16]). Lopez [20] found a negative influence of financial development on income distribution. Clarke et al. [9] explained that the influence of financial development on income inequality depends mainly on the structure of the economy considered. These authors have introduced into their regression an interaction variable between financial deepening and size of the modern sector. In the same order of ideas, Aghion et al. [1] showed that financial development affects economic convergence through productivity growth rather than capital accumulation.

On the other hand, theory of governance and income inequality has been developed, in parallel to empirical studies. Gupta et al. [13] for example found that an increase of one standard deviation in corruption increases the Gini coefficient of income inequality by about 11 points. Bowles [6] has coined the expression "institutional poverty traps" to refer to institutional arrangements that engender inequality. Bourguignon et al. [5] call for a systematic analysis of the effect of institutions, in the current and future research agenda on the persistence of inequality[2].

Some studies have either examined a hypothesized relationship between financial development and governance. Mayer and Sussman [23] highlighted that regulations concerning information disclosure, accounting standards, permissible practice of banks and deposit insurance do appear to have material effects on financial development. Using a sample of former colonies, Beck et al. [4] found that both the legal systems brought by colonizers and the initial endowments in the colonies are important determinants of stock market development and private property rights protection. Huang [15], using a panel dataset of 90 developed and developing countries over 1960-1999, revealed that political liberalization is typically followed by a higher level of financial development at least in the short-run, particularly for lower-income countries, ethnically divided countries and French legal origin countries.

All in all, only a few studies have focused on the multi-faceted relationship between financial development, governance and income inequality. Rajan et al. [25] for example argue that financial development

[2] pp. 250-253.