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Do Financial Reforms Help Stabilize Inequality?

Dimitris Christopoulos* Peter McAdam†

***Highlights**

- Explores relationship between financial reforms and income inequality using
- 29 countries over 1975-2005.
- Extend panel unit root tests to allow for the presence of some financial-reform covariates and structural breaks.
- Both gross and net Gini indices follow a unit root process
- This picture can change when financial reform indices are accounted for.
- Gross Gini coefficients not stabilized by financial reforms, net measures are (more likely to be).
- Financial reforms enacted in the presence of a strong safety net seem preferable.

Abstract

We explore the relationship between financial reforms and income inequality using a panel of 29 countries over 1975-2005. We extend panel unit root tests to allow for the presence of some financial-reform covariates and further suggest an associated but novel, semi-parametric approach. Results demonstrate that although both gross and net Gini indices follow a unit root process, this picture can change when financial reform indices are accounted for. In particular, whilst gross Gini coefcients are generally not stabilized by financial reforms, net measures are (more likely to be). Thus financial reforms enacted in the presence of a strong safety net would seem preferable.

JEL: C01, C12, D63, G15.

Keywords: Inequality, Gini Coefficient, Financial Reform, Unit Root, Panel, Fractional Integration.

1 Introduction

In recent decades and across many countries, inequality – as measured by the Gini coefficient – has risen (e.g., Guest and Swift (2008), Solt (2009)). Over the same period there has been a global push to reform and deregulate the financial sector.

That financial reforms (FRs) and income distribution interact is straightforward to motivate (e.g., Kumhof and Ranciere (2015), Agnello et al. (2012), Claessens and Perotti (2007)). For instance if inequality reflects unequal access to funds by those with poor credit histories or limited collateral, then better functioning, more accessible financial markets might reduce income dispersion. However, if credit flows mirror the (typically uneven) distribution of abilities, then financial deepening might exacerbate inequality. Overall, though, the literature has generally taken a positive perspective on the issue, see the seminal studies of Beck et al. (2007) and Demirgüç-Kunt and Levine (2009).

Our contribution is to re-examine this link – but from a novel and distinct perspective. Using a series of covariance stationarity and long-run memory tests, we analyse the univariate properties of the income inequality index taking into consideration the information contained in the FR measures.

A conventional approach to analyzing the reforms-inequality link might be to test for a common trend. But cointegration does not make sense here. First, cointegration between two or more series requires that, although the variables are non-stationary, a linear combination is

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