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Effect of Bank-Based or Market-Based Financial Systems on Income Distribution in Selected Countries

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Abstract

The main goal of this research is to estimate the effect of bank-based and market-based financial systems on income distribution using the data of 15 developed and developing countries. For this purpose, firstly the type of financial system for selected countries was determined. Then the model of research was estimated applying the FMOLS method. In the next step, using OLS method in panel data, the effect of the type of financial system on income distribution of the two groups of developed and developing countries was estimated in order to come up with a better conclusion. The results indicated that the type of financial system affects income distribution. Market-based financial system leads to better income distribution in developed countries, while bank-based financial system reduces income inequality in developing countries.

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Keywords: Income Inequality; bank-based financial system ; market-based financial system ; FMOLS method

1. Introduction

Income distribution is one of the important economic topics. Income distribution means dividing national gross product among production elements that participated in forming and creating added value of the company and in other words, income distribution in economy expresses how national income is divided among social groups and classes and what the performance of the economic system is. Although the topic of income distribution and poverty are traditionally within the framework of micro-economy, it is vastly analyzed in the area of macro-economy

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nowadays. Historical evidences and experiences of different countries show that many factors are effective on the economic inequality level. These factors could be divided into economic growth development, demographical, political, historical, cultural and natural factors and macro-economic factors (Kassa ,2001).
Considering the importance of income distribution in national economy, study of the effect of financial system on income distribution in every economy is important. Thus this research studies the effect of the type of financial system on income distribution. The purposes of this study are to identify whether the financial system of the selected countries is bank-based or market-based and specifically to find out the effect of the financial system of the selected countries on their income distribution.

1.1. Description and statement of research

Studies were conducted in the area of financial development and economic growth that indicate the positive effect of financial development on economic growth. Development of financial systems is in form of a set of institutions and organizations that deal with transfer of money and is in charge of mediation of saving and investing money. Meanwhile all countries have such a system, but comparative study of these systems indicates a considerable structural variation among them. The most important aspect of this variation is whether these systems are bank-based or market-based.

Financial system could be bank-based, securities-based and financial services-based. The bank-based theory emphasizes on the positive role of banks in economic growth and development and shortcomings and failures of the securities-based financial system. According to this theory in developing countries, banks could be more effective than market of securities on the economic growth. The view of being bank-based also emphasizes on the shortcomings and failures of the basis system among which the following point could be referred to that securities - based system has issued the information for the public and in this way it reduces the investors' incentive to seek information. On the other hand, banks remove the disturbances resulting from unbalanced information through establishment of a long-term relation between themselves and firms. As a result, bank-based arrangements could improve the optimal allocation and company governance more than the securities-based systems. Furthermore, securities-based theory explains the advantages of better performance of the market and emphasizes on the problems of the bank-based system.

1.1.1. Relation between Financial Development and Income Distribution

Economic theories show that financial development affects income distribution from different channels. There are two approaches regarding the relation between financial and inequality development that are presented in two different schools. One school was presented by (Greenwood and Jovanovic, 1990) which proves that the relation between financial development and inequality is in form of a reverse U and the second school that was introduced by Benergy and Newman, 1993 and Guller and Zira, 1993 indicates that there is a linear relation between financial and inequality development.

2. Literature Review

2.1. Financial System

Financial market is an official and organized market where funds are transferred from individuals and units that have additional financial resources to individuals and units requiring resources (funds). It goes without saying that in this market, the majority of loan grantors are families and the majority of applicants for these loans are economic firms and government. Financial market facilitates the necessary basis for transfer of savings from natural persons or legal entities to other individuals who hold the creative investment opportunities and require financial resources. The mentioned transfer of funds leads to creation of financial properties almost in all cases and is in fact a claim for future incomes of an individual (legal entity) who has issued the negotiable papers of stock exchange (Shabahang ,1996)