Persistent Poverty: The Forgotten Role of Finance

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Introduction

- Financial development boosts growth
  - By improving capital allocation
  - In developing countries and the US states
- But, does finance help the poor?
  - Does it primarily help the rich?
  - Does it support balanced growth?
  - Does it primarily help the poor?
Who cares?

- Human suffering of destitution:
  - 50% live on less than $2/day.
  - 25% lack clean drinking water.

- Relative Income differences …
  - Poorest 20% earn less than 2% in many countries.
  - USA: Inequality grew by 30% during the last 30 years.
  - USA: Median wages grew 10%. Wages of top 1% grew 100%.
  - May hurt social commitment to growth policies.
Who cares?

“My major problem with the world is a problem of scarcity in the midst of plenty ... of people starving while there are unused resources ... people having skills which are not being used.” – Milton Friedman
How might finance fit?

- Funds connected
  - Intensifies inequality
  - Slows growth

- Funds best projects
  - Equalize opportunity
  - Speed growth

Both can be correct, depending on How the financial system works
How does financial policy fit?

- World Bank is de-emphasizing finance.
  - Accept: Finance $\rightarrow$ growth link
  - Question: Finance $\rightarrow$ poor link
- What do the data say?
Question #1

- Does banking development disproportionately help the poor?
  - Examine poorest 20%
  - Control for average growth
  - Control for other country traits
  - 1960-2001
Banking development disproportionately helps the poor.

If Brazil had Korea’s banks, income of the poor would have growth at 3.2% (rather than 2%). Income inequality would have shrunk, rather than expanded.
Question #2

- Does banking development reduce income inequality?
  - Control for average growth
  - Control for other country traits
  - 1960-2001
Banking development reduces income inequality
Question #3

- Does banking development reduce destitution?
  - Control for average growth
  - Control for other country traits
  - 1980-2000
Banking development helps the very poor, but the relationship is weaker.

If Peru had Chile’s banking system, 6% living would be living on less than $1/day, rather than 10%.
Around the world …

- Banking development:
  - Boosts overall growth
  - Disproportionately helps the poor
  - Asides:
    - Other policies do not have this impact
    - Government banks do not work
    - Government SME programs do not work

- But, what about the USA?
US States

- Most US States had restrictions on intra-state bank branching for much of the 20th century.
- This reduced competition.
- Starting in the 1970s, individual states reduced these restrictions.
  - Competition increased.
  - Bank efficiency improved.
  - Growth accelerated.
Bank Branching Deregulation

- What impact did branch deregulation have on the distribution of income?
  - Overall, income inequality rose.
  - But, did bank branching deregulation accelerate, or slow this trend?
What we did …

- Family income
- Control for
  - State fixed effects
  - State welfare programs
  - State growth
  - State taxes and expenditures
  - Time trend
Reduces inequality by 10% of its growth during the last 3 decades.
Conclusions

- Broad political enthusiasm for
  - Entrepreneurship
  - Equal Opportunity
- Financial development can affect
  - Equality of opportunity
  - Poverty
- Development policies need to catch-up to theory and evidence