Finance and Opportunity

Financial development disproportionally helps the poor and small firms

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Are a person's economic opportunities determined by individual skill and initiative, or are his/her horizons shaped by parental wealth, human capital and social networks? In considering these age-old questions, we analyze the role of the financial system in shaping economic opportunities and affecting the transmission of poverty and income inequality across generations.

It is difficult to overestimate the potential welfare implications of enhancing economic opportunities in general and those of the poor in particular. Almost 3 billion people — about half of the earth's inhabitants — live on less than US$2 per day. Many live in the same impoverished conditions as their parents and grandparents.

Financial market imperfections — such as information and transaction costs — are a keystone of virtually all theories of persistence in relative incomes across generation. For example, financial market imperfections determine the extent to which the poor can borrow to invest in schooling or physical capital. Financial market imperfections also determine the extent to which comparatively talented, but poor, individuals can raise external funds to initiate projects.

The theories generally take financial market imperfections as given and unalterable. Yet, economic conditions, technological change, and financial sector policies and innovation can all affect the level and evolution of financial market frictions. Depending on laws and policies, financial contracts, markets, and institutions may ameliorate or intensify the adverse effects of financial market frictions on economic opportunities.

Two Common Public Policy Alternatives

Theoretical models have stressed two public policy strategies for reducing the persistence of income differences across generations:

- *Income and wealth redistribution policies*, which reduce the impact of parental wealth on the economic opportunities of their progeny. Redistributive policies, however, create disincentives to work and save, and are directly linked with equalizing outcomes, not simply equalizing opportunities.
- *Public education policies*, which reduce inequality of economic opportunities.

Financial development policies that expand individual economic opportunity create positive incentive effects, while avoiding the tensions associated with redistributive policy attempts to equalize outcomes. Moreover, financial development policies that reduce credit market imperfections help the poor to borrow in order to invest in human capital accumulation, thereby improving their economic opportunities.

Finance Can Disproportionately Help the Poor

What does empirical evidence tell us about the linkages between the operation of the financial system and distribution of income and poverty?

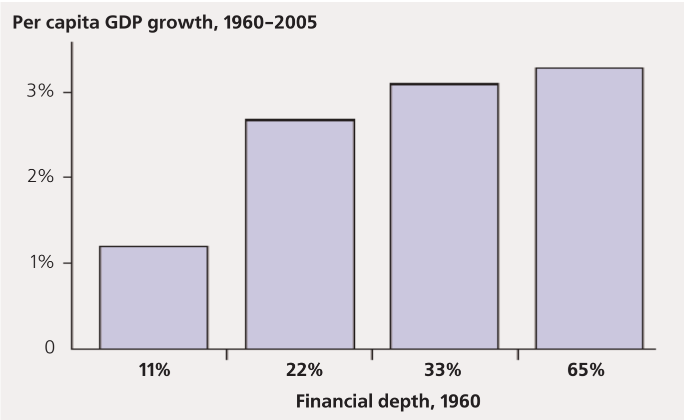
A lot of studies find that financial development, as measured by financial depth (such as credit extended to the private sector divided by GDP per capita) accelerates aggregate economic growth, and that aggregate growth, the income of the poor, and inequality are interlinked. Thus, if financial development does not intensify income inequality (too much), financial development will reduce poverty by boosting overall economic growth. If, however, financial development intensifies income inequality, then this income distribution effect could negate — or even reverse — the poverty-reducing effect of financial development. Financial development might disproportionately help the poor, by affecting poverty through two channels: overall growth and a flattening of the distribution of income.

Indeed, research on Gini coefficients finds that financial development is associated with lower levels of income inequality. For example, we have found that financial development boosts the growth rate of the income share of the poorest quintile, thus helping the poor above and beyond the impact on aggregate growth. About 40% of such impact is the result of reductions in income inequality, while the remainder of the impact is due to the effect of financial development on aggregate economic growth.

How is finance related to actual poverty, and not just to income distribution? Several cross-country studies have found that financial development is negatively correlated both with poverty and the growth rate of poverty. For example, a recent study finds that about half of the impact of financial development on the headcount measure of poverty is due to financial development accelerating economic growth, and the other half is due to financial development reducing income inequality.

Financial market imperfections help sustain income inequality and poverty traps by hindering the ability of the poor to accumulate income-enhancing human capital. Various international studies show that lack of access to credit:

Finance Boosts Growth



- Forces poor households to reduce their children's education, especially in case of transitory shocks;
- Reduces average secondary school enrollment rates;
- Encourages child labor.

Finance Boosts Small Firm Growth Disproportionately More

Moreover, financial constraints hinder efficient investment. To the extent enterprises cannot access finance to undertake promising investments, this is likely to exacerbate inequalities and lead to poverty traps. In many developing countries small and medium enterprises face difficulties accessing finance, due to the absence of credit information and connections. Research in this area shows that:

- A greater proportion of firms financed their growth externally in countries with more developed financial systems and more efficient legal enforcement;
- The growth of smaller firms is significantly more constrained by financing obstacles, particularly in countries with less developed financial systems;
- Financial development boosts the growth of small firms disproportionately more.

In the presence of credit constraints, the biggest firms may not be run by the best entrepreneurs, but rather by the wealthy, which has adverse implications for economic efficiency and income inequality. Thus, a CGE model developed by Caselli and Gennaoli in 2002 shows that efficiency costs of this misallocation of talent leads to large productivity losses and can explain as much as 50% of cross-country differences in total factor productivity.

Microfinance — specialized institutions that serve the poor — seeks to overcome the obstacles keeping the poor from accessing finance. Yet while microfinance programs increase access to financial services to those participating in the program, they are very costly to operate and typically require extensive subsidies. Moreover, in developing countries it is not only the poor, but also the middle class who lack access to financial services. Hence, the attention of the development community is currently shifting to improving access for all underserved groups. Focusing on broader access more generally is likely to have higher pay-offs in terms of poverty reduction.

Conclusions

Clearly, lack of access to finance is especially binding on the talented poor and the micro and small enterprises that lack collateral and credit histories. Without access, poor individuals and small enterprises need to rely on their personal wealth or internal resources to invest in their education, become entrepreneurs or take advantage of promising growth opportunities.

Existing evidence on financial development, inequality and poverty is encouraging. However, most of the macroeconomic literature uses financial depth measures instead of indicators that would capture broad access, and microeconomic studies use financial wealth to proxy for credit constraints. Better measurement and evaluation of impact can help research make progress in understanding which financial services are important in promoting growth and poverty reduction. These results will in turn influence the design of policy measures and financial sector reforms to broaden access.

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Financial Indicators for Selected Countries in Europe and Central Asia, 2005
(including the regional comparator)

	Banking Sector – Size Index	Banking Sector – Efficiency Index	Banking Sector – Stability Index	Equity Market – Size Index	Bond Market – Size Index
Czech Republic	5.275	4.265	4.426	n/a	4.916
Estonia	5.265	6.092	3.981	n/a	n/a
Georgia	4.314	3.990	4.499	n/a	n/a
Hungary	5.418	5.545	4.633	n/a	6.430
Kazakhstan	4.907	5.593	2.887	4.758	n/a
Poland	4.970	5.343	5.358	5.075	4.658
Romania	3.581	3.613	5.111	4.805	n/a
Russia	4.848	5.351	4.380	6.174	3.890
Slovak Republic	5.091	4.855	5.454	4.605	n/a
Ukraine	5.028	5.352	2.344	4.707	n/a
Turkey	4.350	5.198	5.378	6.308	5.008
Europe and Central Asia	**5.989**	**4.990**	**4.622**	**6.081**	**6.615**

Index values range from 0-10, with a higher score indicating greater sophistication.
The full descriptions of indicators comprising each index can be found at www.financial-indicators.org.

Source: The World Bank Group