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Financial development and income inequality in Africa

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Abstract

Across the globe, a rise in income inequality has been experienced for the last two decades, particularly in developing countries. This problem of income inequality poses a challenge to Africa's ability to attain the United Nations (UN) Sustainment Development Goals (SDGs) of reduced inequalities (SDG-10). Against this backdrop, there is a need to harness the potential of financial development to reduce income inequality in Africa. Therefore, this study empirically examines how financial development affects income inequality in Africa. Financial development dimensions, access, depth, efficiency, and stability were considered to achieve the study's objective. The study applied the system generalized method of moments (SGMM) to analyse data and the findings showed that each dimension of financial development had a varying impact on income inequality. Access, stability and efficiency components of financial development reduce income inequality, while the depth dimension of financial development exacerbates income inequality in Africa. Therefore, the study recommends that policymakers should not neglect other dimensions of finance in facilitating economic development.

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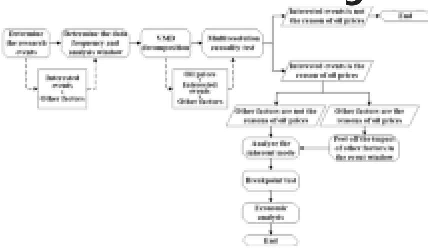

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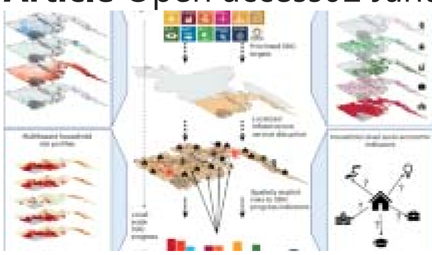

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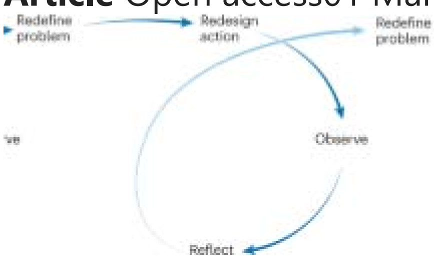

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Introduction

The negative impact of income inequality on development has prompted much research to be devoted to find ways to eradicate the problem. Income inequality is as much social problem as an economic problem (Martin et al., 2021). The result of persistent income inequality can lead to civil wars, some of which have been witnessed in African countries such as the Arab spring revolution (Nabi, 2015). Therefore, income inequality is a multidimensional problem that cannot continue unaddressed. More so, the continuous rise in income inequality across the globe, particularly in Africa, poses a threat to the actualization of the United Nations (UN) sustainable development goals (SDGs) reduction in inequalities (SDG-10). Thereby, the study of income inequality has gained relevance in recent literature as income inequality threatens the development process of an economy. On this note, financial development is being proposed to alleviate income inequality. This is because financial development has to do with capital allocation.

The development of the financial system can lead to the relaxation of constraints that hinders capital redistribution, thereby causing the poor to access funds for productive activities which in turn promotes income inequality reduction. However, the reality is contradictory to the theory. Economies that have been witnessing steady financial development have recorded increasing income inequality. One such economy is South Africa, which is the most unequal sub-Saharan African country as of 2017 despite having a mature financial system (United Nations Development Programme, 2017).

According to Demirgüç-Kunt et al. (2017), the poor and most vulnerable people are highly excluded from the financial system. The poor and less privileged are most likely to get funds for business and entrepreneurship from informal savings clubs (Thornton and Tommaso, 2020). Most literature on financial development has focused on the depth dimension of financial development. Focusing on the depth dimension of financial development is a narrow way to examine financial development. Makhlouf et al. (2020) showed that financial development widened income inequality in advanced countries, while Seven and Coskun (2016) found that financial development exacerbated income inequality in low-income and emerging countries. Kim and Lin (2011) indicated that the financial development stage could affect how finance affected income inequality. However, Altunbaş and Thornton (2019) used total financial development covering access, efficiency and depth and found that financial development facilitated income inequality reduction in the upper middle and low-income countries. Following these contradicting results, it is essential to evaluate the effect of financial development on income inequality in Africa by considering the dimensions.

Čihák et al. (2012) categorized financial development into four dimensions: access, depth, efficiency, and stability. Access explains the ability of people to receive funds whenever and wherever they need it. The depth dimension describes the volume of the financial system; efficiency illustrates the ability of the financial system to perform its functions of mobilization of funds and capital allocation at minimum cost, while stability captures the likelihood of the financial system to default. These dimensions characterize a well-developed financial system. Thus, focusing on one aspect of this dimension in understanding the effect of financial development on income inequality would not holistically explain financial development.

Furthermore, the rate of technological development across the globe has led to more focus on the effect of financial inclusion on income inequality (Erlando et al., 2020; Menyelim et al., 2021; Omar and Inaba, 2020). The drive for financial inclusion has led to notable increases in the participation of the poor and vulnerable in the financial system (World Bank, 2018). Thus, increased access to financial products and services could increase the usage of financial products by the poor and vulnerable, leading to a more efficient capital allocation that can facilitate income inequality reduction. This was supported by the study of Babajide et al. (2015), which found financial inclusion to be a significant determinant of factor productivity.

Neaime and Gaysset (2018) indicated that financial inclusion enables a more even distribution of income in MENA countries. Nonetheless, the drive for financial inclusion could threaten the stability of the financial system. Fouejieu et al. (2020) pointed out that increased access to financial products and services could make the financial system more liable to shocks, thus putting the financial stability dimension in question. Hence, all four dimensions of financial development play a significant role. Therefore, this study evaluates financial development based on the dimensions classified by (Čihák et al., 2012).

In addition to the dearth of literature on financial development and income inequality in Africa, previous studies reported mixed findings and focused on a single dimension of financial development. This, therefore, calls for more research on the subject, which forms the basis of this study. This study considers the multidimensional aspect of financial development that has been omitted in the extant literature and pays attention to the peculiarity of Africa

Data used in this study are publicly available online. Data were sourced from the World Bank's World Development Indicators, World Governance Indicators, and Global Financial Development Database. The income inequality data were sourced from the Global Consumption and Income Project.

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Contributions

VIO: conceive and design the experiment; methodology; analysed and interpreted the data; writing-original draft preparation; contributed analysis tools and data. IOO: supervision; writing-review and editing; validation. EB: supervision; resources; writing- review and editing. RO: methodology; formal analysis; writing-original draft preparation.

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Ethics declarations

Competing interests

The authors declare no competing interests.

Ethical approval

Ethical approval did not apply in this study as the research did not include any human or animal participants.

Informed consent

This article does not contain any studies with human participants performed by any of the authors.

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