Does Access to Credit Reduce Inequality? Evidence from Bangladesh

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Access to capital has been recognized as one of the factors that contribute to the higher level of welfare of households. In developing countries, the formal sector financial institutions exclude poor households through the collateral requirement, credit rationing, preference for high-income clients, bureaucratic and lengthy procedures of loan sanctions. On the other hand, informal sector financial sources are exploitative in nature (Bhaduri 1983, Rao 1980, Bardhan 1980, Ghosh 1986, Ghate 1992, Flotz 2004, Pertick 2005). Singh, Square, and Strauss (1986) argue that the relaxation of the liquidity constraint of a household contributes to the better allocation of resources, increases production, increases income and welfare. Foltz (2004) argues that easing of credit constraint significantly increases the profitability of agricultural firms. Imperfections in the financial capital markets significantly contribute to the allocative inefficiency in the production of firm households (Chavas et. al. 2005). Access to microcredit increases income and consumption of households and thus, reduces poverty of participating households (Chowdhury et. al. 2005, Chowdhury and Khandker, 1996).

The available literature indicates that access to finance has positive impacts on income and welfare of the people of a country and thus, it has a negative impact on the poverty in the society. The reduction of poverty in the society does not necessarily reduce inequality in the society. There is evidence in the literature that the inequality in the society goes up while the average income level goes up to a certain level and the level of poverty goes down in the society. There is a gap in the literature in terms of the assessment of the impact of access to finance on the inequality in the society at the micro level. However, there are some available studies that have looked at the relationship between the financial development and the level of inequality in the society through using cross-sectional country-level data sets. The financial development ensures an efficient credit allocation and that leads to the economic development and thus, reduces the inequality in the society. It is also argued that the financial development eases the credit constraint on the poor and increases their ability to increase income and to increase productive assets which in turn contributes to the poverty reduction (World Bank, 2001). Using a cross-country data set, Kai and Hamori (2009) argue that the microfinance sector development has the potential to reduce inequality in a country. Considering the gap in the literature, this study intends to assess the role of access to finance on the inequality in a society at the micro level, i.e. at the household level. In this paper, access to credit has been considered as a proxy of the access to finance.

The inequality has been estimated at the household level through calculating the log mean deviation of per capita consumption expenditures of households. The log mean deviation of per capita consumption expenditures of a household reflects how far that household deviates from the mean in terms of per capita consumption expenditures. The analysis is based on a sample survey of three thousand four hundred eighty-one (N=3,481) households and it is done at the household level. The multivariate technique has been applied to achieve the objective of the paper.

The results indicate that access to credit has a significant and negative impact on the inequality in the society as it negatively determines the log mean deviation of per capita consumption expenditures of households. Similarly, the results indicate that the total amount of household credit also significantly and negatively determines the log mean deviation of per capita consumption expenditures of households and thus, it reduces the level of inequality in the society. Out of seven credit sources, five sources have negative impacts on the inequality at the household level and the remaining two sources have positive impacts on the same inequality. Loans from commercial banks, community-based organizations (CBOs), money lenders, family members and friends and suppliers negatively determines the log mean deviation of per capita consumption expenditures of households and thus, inequality in the society reduces. Out of these sources, only loans from commercials banks and loans from family members and friends significantly and negatively determines the log mean deviation of per capita consumption expenditures of households. On the contrary, loans from microfinance institutions (MFIs) and non-government organizations (NGOs) positively determine the log mean deviation of per capita consumption expenditures of households and consequently, the inequality in the society goes up. Out of these two sources, only the variable on loans from MFIs is statistically significant.