Center for Equitable Growth Grant Proposal
“Financial Liberalization, Capital-skill Complementarity, and Wage Inequality”
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Financial development -defined as the process that marks improvements in the quantity and quality of financial intermediary services- can potentially have important effects on the real side of the economy. There is increasing empirical evidence finding that financial development leads to higher economic growth. Nevertheless, there is almost no evidence on the effect of financial development on income inequality. It is not clear whether improvements in financial markets benefit the whole population, primarily benefit the rich, or disproportionately help the poor.

The purpose of this paper is to study how financial development affects one particular dimension of the income distribution, wage inequality -defined as the relative wage between skilled and unskilled workers. My analysis starts from the point that financial development, by alleviating the extent of credit constraints, should allow firms to increase their capital demand. As a result, firms also increase their demand for labor, both skilled and unskilled. If the production function of the firms exhibits capital-skill complementarity -meaning that capital and skilled labor are relative complements- then skilled labor demand should increase by more than unskilled labor demand. This should lead to an increase in the relative wage of skilled labor in equilibrium, thereby increasing wage inequality.

In a cross-section of countries, I document a positive relationship between private credit to GDP and wage inequality. However, this measure of financial development is highly endogenous. To estimate the causal effect of finance on inequality and test the hypothesis described above, one must rely on an exogenous shock to financial development. In this paper, I focus on two episodes of financial liberalization, which refer to changes in government policies regarding the financial sector, something largely exogenous to economic agents. First, I analyze the deregulation of financial markets in a group of European countries, which liberalized dramatically their domestic credit markets since the 1970s. Secondly, I study the deregulation of geographic restrictions on banking across the individual states of the United States starting in the 1970s.

My empirical strategy relies on exploiting both differences in external financial dependence and capital-skill complementarity (henceforth CSC) across sectors. In particular, financial liberalization should alleviate credit constraints and increase capital demand especially in sectors with higher external financial needs. Within these sectors, the policy should increase the relative demand for skilled labor and thus wage inequality particularly in sectors where capital and skilled labor are strong relative complements. To assess the causal impact of liberalization on wage inequality, I therefore employ a difference-in-difference-in-differences estimation methodology that exploits these two cross-sectoral differences.

I also analyze how the effect of liberalization on wage inequality varies according to a country’s characteristics. First, I study how the effect depends on the county’s labor market institutions. The effect should be stronger in countries with more rigid labor markets, since these have lower mobility of labor across sectors and hence the effect of the reform on cross-sectoral relative wage differentials should be larger. Second, I analyze how contract enforcement strength alters the effect of liberalization on inequality. The effect should be
stronger in countries with stronger contract enforcement, since the reform increases financial depth particularly in countries with strong contracting institutions.

Summing up, financial liberalization is a government policy that can have important ramifications on the real side of the economy. Until now, the main focus of the literature has been on the growth effects of the policy. However, policy makers should also have a clear understanding on the distributional consequences of financial liberalization. The main contribution of this paper is to provide solid empirical evidence that this policy may widen the wage gap between skilled and unskilled workers. The research should be of interest to the Center for Equitable Growth since by analyzing the equity dimension of financial liberalization, in addition to the already analyzed efficiency dimension, I contribute to a better understanding of the overall effects of an important policy reform on the economy.