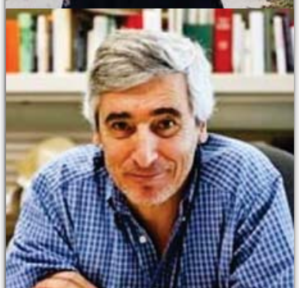

CAPITAL ACCOUNT LIBERALIZATION & INCOME INEQUALITY: 1980-2009

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I examine the relationship between income distribution and the capital market account from 1980 to 2009 across a sample of developed and semi-developed countries. A review of the literature suggests that capital account liberalization raises income inequality. Several factors alleged to contribute to this outcome include increased macroeconomic volatility and financial crises, decreased credit availability for the poor, and weakened progressive tax policies and transfer payments.

Under this theoretical explanation, capital openness increases economic volatility and differentially increases credit availability to the wealthy, increasing the disparity between the rich and the poor. The new capital flows available mostly to the wealthy are expected to mitigate the government's ability to address inequality, thus further exacerbating the increasing effect of CAL on inequality. This relationship is expected to be stronger for developing countries due to their weaker financial and governmental institutions, as well as increased variability in capital openness. The literature is incomplete, with a need for an empirical analysis. I address this gap by testing several panel regressions. I use two measures of income inequality to provide a comprehensive understanding of inequality—the Gini index and Palma index. I use Quinn's (1997) index for capital openness to measure capital account liberalization. The sample selection of 33 countries were chosen based on available data across three decades: 1980s, 1990s, and 2000s. I use these data to test the empirical model and my hypothesis that liberalizing a country's capital market account results in higher income inequality.

I found a positive, statistically significant result for the effect of capital openness on income inequality when using the Gini index, and similar results when I tested the effects on a sample of semi-developed countries using both the Gini and Palma indices. The results of these regressions show that greater financial openness results in increased income inequality, and this effect is exacerbated for developing countries. This has important policy implications for determining domestic financial and welfare policy and suggests there is a tradeoff between liberalization and inequality. These results suggest liberalization may not be the best policy to undertake and if it cannot be avoided, important steps should be taken to mitigate inequality by strengthening financial and governmental institutions.