Income Distribution, Banking Sector Productivity and Government

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Abstract

This work builds a theoretical model to explain the role of government when there is income inequality resulting from a capital market imperfection. Firstly, a two-period general equilibrium model is used to propound the relationship between a certain type of capital market imperfection and income inequality. The model shows that the capital market imperfection occurring in the form of financial intermediary's productivity decrease has a negative impact over income inequality. Secondly, the theoretical model is expanded by adding a form of government which imposes tax to consumer's wage income. The tax rate is endogenized to present the effect of financial intermediary's productivity over tax rate itself. In this regard, there is a positive relationship between productivity of financial intermediary and tax rate. The model also proves the income-inequality-decreasing effect of the tax rate, higher productivity of financial intermediary increases the tax rate which leads to lower income inequality. According to the intertemporal model with government presented in this study, productivity of financial intermediary influences both tax policy of government and income inequality.

Keywords: Two-period Model, Financial Intermediation, Taxation, Income Inequality.

JEL Codes: D63, G20, H20.