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Research Article

Financial Inclusion and Political Instability as Dual Forces Shaping Income Inequality in Pakistan

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Ghulam Ghouse
Department of Economics, Beaconhouse National University, Lahore, Pakistan

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*Corresponding Email:
ghulam.ghouse@bnu.edu.pk
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Abstract
This study examines the role of instability in the political system and financial inclusion in the case of Pakistan. The data sample is from 1998 to 2023. The structural equation model (SEM) is employed to gauge the direct and indirect impacts of financial inclusion and political instability on the unequal distribution of wealth. The findings refer that financial inclusion is the key driver to reduce inequality to give access to financial services. While the political instability leads to an increase the inequality in society. The key findings highlight the importance of financial inclusion in reducing income inequality. This means that political stability is crucial for reducing income inequality. This study provides a comprehensive database and analysis. It offers evidence and insights for policymakers to achieve sustainable development and financial inclusion in Pakistan.
Keywords: Income Inequality, Financial Inclusion, Political Instability, Economic Growth, SEM.

Introduction
Income disparity is one of the most persistent issues that affects the welfare of societies all over the globe by creating economic and social problems that constrain the stability in the long run (Birdsall, 2001; Umair et al., 2024; Paddu et al., 2025). The unequal distribution of the income is not only a threat for the social harmony but also it limited the prospects of economic growth sustainability (Chang et al., 2024; Qadeer et al., 2024), while addressing the income inequality in developing economies such as Pakistan, it is much necessary for building a fair and prosperous economy which leads to increase the welfare of the society (Nasir, 2024). While there are many other factors but one of the most critical factors that contributes in the increase of income inequality is macroeconomic instability which further leads to the disparities in the wealth (Islamiah, 2025). Pakistan is one of the most relevant case studies to examine the causes of income inequality (Ahmed et al., 2024), as the Pakistan economy is facing many social and economic challenges including high fluctuation in inflation rate, less stability in the political system (Nasir, 2024). A very limited access to the financial services for a very large portion of the population where the financial inclusion provides the ability to an individual to access the financial system and take the financial services like banking, digital transactions, credit, insurance fax which ultimately leads to reduce the income inequality. The purpose of this study is to explore the interlinkages between political stability and financial inclusion in shaping the distribution of the income in Pakistan.

The relationship between financial inclusion and the unequal distribution of the wealth is very relevant, particularly in the case of Pakistan (Khan & Khan, 2024), where a very large population has no access to the financial tools and they are excluded from the formal financial system (Zaib et al., 2025). With a very limited access to the financial services, the individuals are not able to save, which leads to invest in different available opportunities that could improve their economic status in the society (Adelaja et al., 2024). This exclusion of the population from the financial system perpetuates a vicious circle of poverty, which is widening the gap between have and have not (Li et al., 2025). Furthermore, the instability in the political system has also played a very significant contribution in shaping the economic development of the economy (Rashid & Rashid, 2024). A stable political system is very much important for the consistencies of the policies that leads to the economic inclusion and also guarantees the equal distribution of the resources in the economy (Adanma & Ogunbiyi, 2024). While on the opposite side, the political instability commonly leads to be a certain reason of political instability, uncertainty, which is a constraint for economic development and increase the income inequality (Kebalo & Zouri, 2024).

The purpose of this study is to explore the complex correlations between the political instability and financial inclusion which leads to affect the income inequality in case of Pakistan. By using the empirical data and analyzing the potential factors that are contributing towards the income inequality, this study seeks to provide some useful insights that can be useful for policymakers in designing flexible strategies to mitigate the income inequality and which leads to foster the more inclusivity in the economy. This research also discusses the importance of the financial inclusion in the economy as a tool of economic empowerment of the individuals and particularly focusing on the potentials that reduce the negative impacts of macroeconomic instability on income distribution.

Literature Review

There is a plethora of studies have been done on the income inequality, which shows that income inequality is a central concern in the field of the development economics since economic inequality and financial inclusion and political instability, particularly in the case of Pakistan. From a very long history, Pakistan the main goal of the development economics is to provide the policies against poverty (Arkauti et al., 2024). Gibrat proposed the Income Distributions Theoretical Framework which is suggesting that the income of any individual fluctuates stochastically and proportionately (Fontanelli, 2025). Asad and Ahmed (2011) examined the relationship between the consumption inequalities and economic growth. The study concluded that the poverty tends to eliminated with the enhancement of economic growth which leads to reduce the income inequality (Noreen et al., 2022). This indicates that only economic growth is not a sufficient condition for the reduction in income inequality. The study concluded that the target should be the target interventions promoted financial inclusion and macroeconomic stability are also very important.

There is a number of studies which are consistently figure out that there is a need of consistent policies that enhance the development of financial inclusion to reduce the inequalities in the world (Zahnd et al., 2019; Bernard et al., 2023; Verma & Giri, 2024), particularly in developing countries such as Pakistan (Noreen et al., 2022). Many studies with a concise focus on the micro-level issues argued that the education and the differences between urban and rural populations are the cause of income inequality, while there is a small portion of studies which analyze that the macroeconomic indicators are contributing to the unequal distribution of income over the long run, like (Kundu et al., 2024; Gulaliyev et al., 2025; Fatemah & Haq, 2024), but there is a significant gap in the literature on the context of the political instability and financial inclusion, while there are many studies focused on the relationship between the globalization and technological advancement impacts on income inequality (Tabash et al., 2024). This study is aimed to fill the gap by integrating these factors related to the digitalization and the financial technology adoption in case of Pakistan.

The purpose of this study is to fill the gap which is promenaded by reviewing the literature above which provide a way to think about the financial inclusion and political instability impacts on the unequal distribution of income in Pakistan. Through examination of this relation, this study purpose is to provide a very comprehensive analysis with some policy suggestions that can be very useful for the policy maker in the reduction of unequal distribution of wealth in Pakistan.

Theoretical Framework

This study based upon different theories which were established to analyze the income inequality including the well-known Kuznets curve (Huynh, 2024), for income inequality, institutional theory (Lu, 2024), and the theory of human capital (Degu & Singh, 2025). These theoretical frameworks provide a sound footing to the analysis of this study by explaining that the institutional quality, development economics, and human capital investment leads to affect the income distribution, which further leads to the macroeconomic stability (Carlin & Soskice, 2024). While the financial instability hypothesis, theory of business cycle, and the government policies implication highlights how fluctuations in economic and political actions ultimately affect income distribution (Ozili, 2024). These models show the political and financial conditions directly and indirectly affect the income inequality levels. Based upon these theories and by combining the common linkages of these theoretical frameworks, the financial inclusion and political instability are considered to be the main factors to reduce the income inequality. While the term financial inclusion refers a very vast sense, which means that a large excess of the individual to the banking and the credit services, which supports the small and large businesses and the households which reduced the disparities. While political instability has negative effect, but the reduction in political instability ensures the consistency of the policies and it increases the trust of the people in the institutional institutions, which ultimately encourage the investment and growth.

The model is also considered the interactions between political instability and financial inclusion together. These linkages create a very strong, significant impact on the distribution of income, then either a single factor alone, while the key macroeconomic indicators are also included in the study, like trade openness, inflation, GDP growth, budget deficit, while the budget deficit is included as a control variable. These factors affect the income inequality indirectly and also provide a way to check the sole impact of financial inclusion and political instability. The data for this study is collected from World Development Indicators.

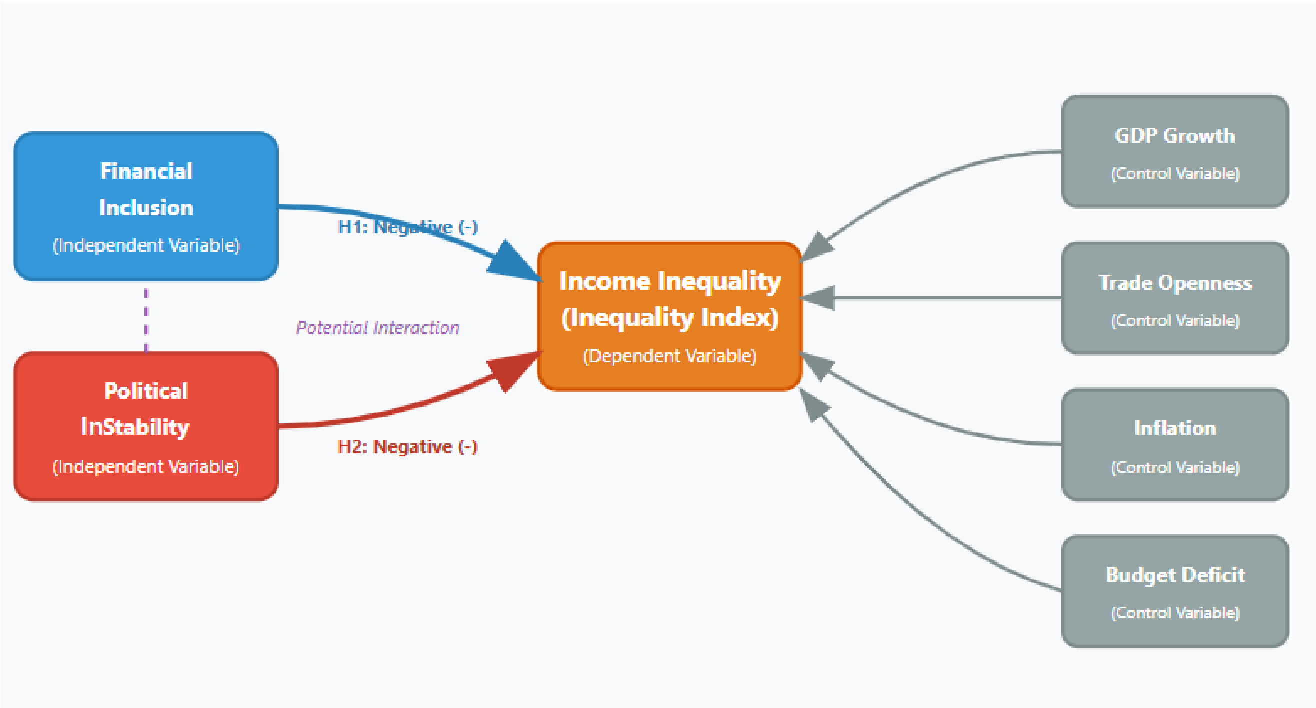

Figure 1. Graphical representation of theoretical framework.

Methodology and Data Description

The data is taken from WDI on the variables from 1998 to 2023 for Pakistan. The structural equation modeling (SEM) (Ghouse et al., 2025; Aslam et al., 2025; Aslam & Ghouse, 2025) is used to find the direct and indirect relations between the variables. The mathematical equation of the model is:

$$II_t = f(FI, PI, TO, INF, DB) \quad (1)$$

The econometric equation of the model is:

$$II_t = a_0 + a_1 FI_t + a_2 PI_t + a_3 TO_t + a_4 Inf_t + a_5 BD_t + e_t \quad (2)$$

In Equation 2, the variable II represents income inequality, which is measured by the distribution of income within households in an economy and its deviation from the standard income distribution. The FI variable represents financial inclusion, estimated by the WDI, and reflects the affordability of financial tools and services for individuals and businesses. The PI variable represents political stability, indicating the likelihood of government changes over time in a country. This is also referred to as the competition between political parties in the economy. TO represents trade openness, which is the total percentage of trade in GDP, estimated by the WDI. Inflation refers to the growth rate of the consumer price index, and BD is the budget deficit, which is assessed through an index that highlights budget challenges and financial management issues. This is estimated by the CPIA.

Results and Discussion

Table 1. Descriptive statistics.

Statistics	GDP	BD	PI	Inf	TO	FI	II
Mean	22.591	3.440	-2.045	8.185	28.862	3.699	96.024
Std	1.493	0.263	0.558	4.806	3.838	1.280	46.859
Min	19.938	3.000	-2.810	2.529	21.460	1.206	36.395
25%	21.787	3.500	-2.474	4.143	25.472	2.995	48.889
50%	22.352	3.500	-2.252	7.599	29.470	3.894	100.000
75%	23.493	3.500	-1.638	9.740	32.320	4.683	140.108
Max	25.387	4.000	-1.105	20.286	34.349	5.789	180.012

Table 1 presents the descriptive statistics of the data. The mean values range from 96 to −2.045. The highest mean is for income inequality (about 96), and the lowest mean is for political instability (about −2.04). The standard deviation ranges from 46.8 to 0.55. The largest standard deviation is for income inequality (around 47), and the smallest is for political instability (around 0.5). The highest observed value is 36.3 and the lowest is −2.8. For the first quartile (Q1), the highest value belongs to income inequality (around 48.9), while the lowest belongs to political instability (around −2.3). For the second quartile (Q2), the highest value is 100 and the lowest is −2.3. For the third quartile (Q3), the highest value is 140 and the lowest is −1.6. The maximum overall value is 180 and the minimum is −1.105.

Figure 2 given below illustrates the path of traits and the indirect relationships between the variables. Income inequality (II) is the dependent variable. Financial inclusion and political stability are the independent variables. Inflation, GDP growth, budget deficit, and trade openness are included as control variables in the model. The arrows indicate the direction of the relationships. The arrowheads show the impact of one variable on another. There are both direct and indirect relationships. First, the independent variables affect the control variables, which then influence income inequality. These are the indirect relationships between the independent and dependent variables.

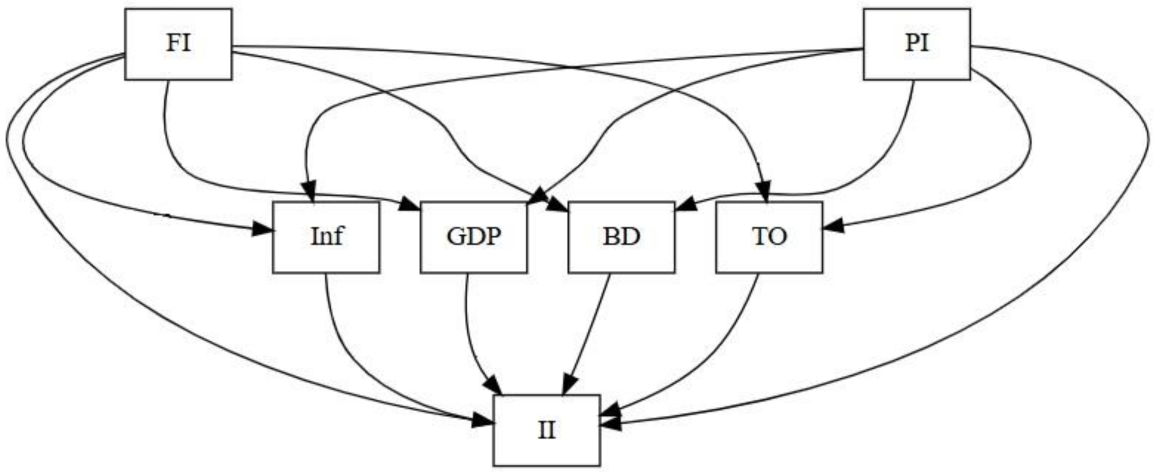

Figure 2. The paths for direct and indirect relationships.

On the other hand, there are direct relationships between political instability and income inequality, as well as between financial inclusion and income inequality. Table 2 below shows the significance of these variables and their impact on the dependent variable.

Table 2. Results of SEM model for direct and indirect relationships.

Lval	Op	Rval	Estimate	Std. Err	Z-Value	P-Value
BD	~	PI	0.0258	0.1140	0.2264	0.8209
BD	~	FI	-0.1471	0.0497	-2.9617	0.0031
Inf	~	PI	0.4833	0.1917	2.5209	0.0059
Inf	~	FI	-1.6134	0.0803	-20.0916	0.0000
TO	~	PI	-2.5748	1.0734	-2.3988	0.0043
TO	~	FI	0.0564	0.0032	17.6245	0.0000
GDP	~	PI	-0.3025	0.6926	-0.4368	0.6623
GDP	~	FI	0.8136	0.3017	2.6969	0.0070
II	~	PI	3.8556	1.1021	3.4984	0.0000
II	~	FI	-2.9932	1.1235	-2.6641	0.0013
II	~	GDP	-1.1343	0.6045	-1.8763	0.0706
II	~	BD	1.2272	0.4630	-2.6503	0.0070
II	~	Inf	0.8343	0.4652	1.7935	0.0940
II	~	TO	-2.1803	1.0721	-2.0338	0.0042

Table 2 presents the relationships of the independent and control variables with the dependent variable. We first discuss the direct relationships. In Table 2, the heading Lval refers to the variable on the left-hand side of Equation 2 (the dependent variable, income inequality), while Rval refers to the variable on the right-hand side (the independent or control variables). The first relationship is between political instability and income inequality. The coefficient is about 3.85 with a p-value of 0.000, indicating a highly significant and positive effect. This means that higher political instability leads to higher income inequality. The second variable, financial inclusion, shows a negative relationship with income inequality. Its p-value is 0.0013, which indicates statistical significance. This means that higher financial inclusion reduces income inequality.

GDP growth also has a negative relationship with income inequality. The coefficient is −1.134 with a p-value of 0.076, making it significant at the 10% level. This suggests that higher GDP growth reduces income inequality. Budget deficit shows a positive relationship with income inequality. Its coefficient is 1.227 with a p-value of 0.0070, indicating high significance. An increase in the budget deficit is therefore associated with higher income inequality. Inflation also has a positive relationship with income inequality. The coefficient is 0.83 with a p-value of 0.09, making it significant at the 10% level. This indicates that higher inflation tends to increase income inequality. Trade openness has a negative relationship with income inequality. The coefficient is −2.18 with a p-value of 0.0042, showing that higher trade openness reduces income inequality. There are also indirect relationships. The link between budget deficit and political instability is insignificant. The relationship between budget deficit and financial inclusion is significant and negative (coefficient −0.147, p-value 0.003), meaning that higher financial inclusion reduces the budget deficit. The relationship between inflation and political stability is significant and positive. The relationship between inflation and financial inclusion is significant and negative, showing that greater financial inclusion can reduce inflation. Similar patterns are observed for political instability and financial inclusion with trade openness: political instability negatively affects trade openness (coefficient −2.5, p-value 0.043), while financial inclusion has a positive effect on trade openness. Political instability has a negative but insignificant relationship with GDP, whereas financial inclusion shows a positive and significant relationship with GDP.

Conclusions and Policy Recommendations

The results of this study show that the development of financial inclusion and reduction in the political instability are the critical factors to reduce the inequalities in the income distribution in Pakistan. Policymakers may prioritize the initiatives that increase access to affordable financial tools, especially for the individuals from low-income groups and small businesses. The financial inclusion development can directly impact and ensure the inequality reduction and indirectly improve the budget discipline, reduction in inflation, and also support trade openness. While the political instability significantly and positively increase the income inequality, while the reforms related to the governance and strengthening the institutional framework are very much important to reduce income inequality. Policy in the decision-making process, less fluctuated policies, and rule of law can be a way to stabilize the economic environment. Strategies to increase the GDP growth should also focus on sectoral growth that ultimately increase the income levels of the individual across the heterogeneous groups, while the financial inclusion linkages program with the opportunities of employment and entrepreneurship schemes are the key factors to which can increase the income level of people.

By the implementation of these policies, there is a way forward for the Pakistan economy to get more equitable income distribution while getting economic growth sustainability. The combined effect of political stability and financial inclusion provides a practical implication to reduce inequality in income and promoting the prosperity of the economy in long run.

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