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Performance of Microfinance Institutions: Does Government Ideology Matter?

FERDINAND A. GUL [a], JYOTIRMOY PODDER [b] and ABU ZAFAR M. SHAHRIAR [c,*]

[a] *Deakin University, Burwood, Australia*
[b] *Torrens University, Adelaide, Australia*
[c] *Monash Business School, Monash University, Caulfield East, Australia*

Summary. — We draw on the political economy theory and examine whether incumbent government's political ideology affects the performance of microfinance institutions (MFIs). We collect data on 619 MFIs from 75 countries over the period of 1996–2012 and merge them with country-level data on government ideology and other economic and institutional factors. We find that MFIs operating in a left wing regime have higher portfolio growth rates relative to the ones operating in a right wing or a centrist regime. Furthermore, under leftist political leadership, MFIs have lower funding costs, lower operating costs, and lower default costs. The electoral incentives of left wing governments, however, impair the capacity of MFIs to increase financial revenue. Thus, despite having lower costs, these MFIs are not more sustainable relative to those operating in right wing or centrist regimes. Academics and policymakers devote substantial resources to better understand the conditions under which MFIs are more likely to flourish and deliver on their promises. We contribute to this endeavor by empirically showing that government ideology is an important determinant of MFI performance.
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Key words — government ideology, microfinance institution, growth, sustainability

1. INTRODUCTION

Microfinance institutions (MFIs) have emerged as an important source of entrepreneurial finance at the grassroots level. Today, around 3,700 MFIs provide collateral-free small loans to 230 million customers in more than 100 countries (Reed, Marsden, Ortega, Rivera, & Rogers, 2014). These institutions share a common objective of financial inclusion of the deprived, but their performance varies substantially (Armendariz de Aghion & Morduch, 2010; Banerjee, 2013; Hermes & Lensink, 2011). Some MFIs have grown to reach millions of borrowers and covered overhead and operational costs in the process, whereas others have largely failed to do so. Prior research has devoted a great deal of effort to understand and unravel what might drive these differences. Some of these studies suggest that the macro-institutional environment in which the MFIs operate in could be a key factor to explain the differences. The main findings of this stream of research are that the success of MFIs depends on the macroeconomic context (Ahlin, Lin, & Maio, 2011), financial sector development (Vanroose & D'Espallier, 2013), regulation structures (Cull, Demirguc-Kunt & Morduch, 2011; Hartarska & Nadolnyak, 2007), and institutional environment, such as the level of economic freedom in a country (Crabb, 2008). None of these studies, however, has explicitly considered the role of government in driving MFI success, although the macro-institutional environment of a country is significantly influenced by the electoral policy of its government (Besley & Case, 2003; Clark, 1998; Imbeau, Petry & Lamari, 2001; Kalt & Zupan, 1984). We fill this gap in the literature by examining whether incumbent government's political ideology (i.e., left–right partisan of the party, or the ruler, in power) affects the performance of MFIs. [1]

The microfinance movement began in the mid-1970s based on the premise that every poor individual has entrepreneurial skills and, as such, given access to small loans she or he can start a business and generate income (Yunus, 1999). Neoclassical economists and neoliberal policymakers greatly appreciated this model of self-help and individual entrepreneurship, whereas the socialists showed distrust to a movement that is anchored in capitalist principles. Hence, many believed that microfinance institutions are less likely to flourish in a political system, where state intervention is encouraged (Bateman & Chang, 2012). Over the past four decades, however, both microfinance and the focus of development policy have evolved. On the one hand, microfinance has evolved to a more comprehensive financial mechanism that provides access to credit, savings, payments, and insurance services to all the unbanked people in low-income communities. On the other hand, financial inclusion of the poor has received a soaring attention in the policy-agenda of governments across the world irrespective of their ideological leaning (Allen, Demirguc-Kunt, Klapper, & Peria, 2012). It is, therefore, not surprising that in many countries, left-leaning governments not only coexist but also cooperate with MFIs.

Consider the experience of Latin America, for example. Many Latin American countries have recently witnessed a resurgence of leftist political movement. In these countries, left wing parties committed, during electoral campaigns, to provide "an easy access to cheap credit" to low-income people—i.e., their core constituencies. After commencing the office, they primarily relied on MFIs in order to fulfill their commitments because a well-functioning state-run banking sector was absent (Bédécarrats, Bastiaensen, & Doligez, 2012). Consequently, they expanded microfinance programs in rural areas, modified the regulatory framework to ensure

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low-cost financing to MFIs, and linked many micro-lenders to state-run social welfare programs. At the same time, these governments have criticized microfinance operations because of the high level of interest rates, and took initiatives to impose ceiling on loan prices. These anecdotal references indicate that MFIs may thrive under left wing governments in terms of portfolio growth and cost minimization but not overall profitability.

To explore the link between government ideology and MFI performance, we collect data from multiple sources. We collect data on MFIs from the Microfinance Information Exchange (MIX Market: www.mixmarket.org). Data on government ideology are collected from the Database on Political Institutions (DPI) compiled by the World Bank. In particular, we collect information on the political ideology of the major party (i.e., the party with the highest vote share) in government, and that of its chief executive. Data on macro-institutional factors have been collected from various sources of the World Bank. We employ a fixed-effect estimation model to our panel data, and analyze the relationship between government ideology and two broad measures of MFI performance: growth and sustainability. Growth of an MFI is measured in terms of the size of its total loan portfolio. Sustainability refers to operational self-sufficiency, i.e., the ratio of financial revenue over total annual expenses of an MFI. Annual expenses are decomposed into three components: cost of funds, operating costs, and default costs (or impairment loss).

Our findings indicate that MFIs operating in a left wing regime enjoy higher portfolio growth rates relative to the ones operating in a right wing or a centrist regime. Furthermore, under leftist political leadership, MFIs have lower average cost of funds, lower operating costs, and lower default costs. Despite having lower costs, however, these MFIs are not more sustainable because they generate lower levels of financial revenue relative to those operating in right wing or centrist regimes. Our results further suggest that the influence of government ideology is stronger among not-for-profit MFIs compared to their for-profit counterparts.

We conducted several robustness checks. Prior research suggests that the impact of government ideology on economic policymaking may depend on the political system of a country because the constituents' preferences are reflected in a different manner in a presidential system relative to that in a parliamentary system (Horowitz, 1990; Samuels, 2004). For instance, it is the legislators who are accountable to the voters in a parliamentary system, whereas in a presidential system, voters—largely speaking—reward or punish the president. Accordingly, we use the ideological orientation of the chief executive for political systems classified as presidential in the DPI database, and that of the largest party in government for systems classified as parliamentary. We find that our main results hold when we use this alternative definition of political ideology. Next, we remove the MFIs from our sample that operate in a radical left or a radical right wing regime. Prior research suggests that the radical left and the radical right governments may differ in their perceptions of certain institutions as hostile or friendly, but they share a common style of political thought and employ similar techniques of political engagement (McClosky & Chong, 1985). Thus, the presence of radical left and radical right wing governments in the same sample may introduce a noise in the estimation. After the removal of the MFIs that operate in a radical political regime, however, our main findings hold. In the final robustness check, we identify episodes of regime change in a country—from right to left—both preceded and followed by four years of uninterrupted regime. Using a simple regression framework, we compare performance indices of the same MFI before and after the regime change. The results suggest that following the regime change, MFIs enjoy a higher portfolio growth rate and a reduction in financial expenses and financial revenue. These results strengthen our argument that the incumbent government's political ideology is an important determinant of MFI performance.

The remaining sections of the paper proceed as follows. In Section 2, we discuss the relevant literature and develop our testable hypotheses. In Section 3, we describe the data and method of empirical investigation. In Section 4, we report the results. In Section 5, we discuss the implications of the findings and the limitations of the study. Section 6 concludes the paper.

2. BACKGROUND LITERATURE AND HYPOTHESES

Policymakers are self-interested agents, who respond to electoral incentives (Hibbs, 1977, 1992). As such, policies pursued by left and right wing governments are broadly in accordance with the objective economic interests and subjective preferences of their median voters. Stylized observations indicate that blue collar working people make up the core constituency of left wing parties. They primarily rely on earnings from labor, and occupy lower status unsheltered jobs. In contrast, up-scale white collar groups form the core constituency of right wing parties. They hold the lion's share of financial capital in the household sector, and occupy higher status secure jobs (Hibbs, 1992). Electoral incentives, therefore, motivate left and right wing parties to adopt different policies toward core development issues such as poverty, unemployment, and inequality. For instance, left wing parties tend to advance welfare programs—such as cash transfer to the eligible poor—whereas right wing parties tend to inhibit it because of its potential redistributive impact on national income (Hicks & Swank, 1984; Hicks, Swank, & Ambuhl, 1989).

There are two specific ways through which politicians interfere with financial markets in general and, banking business, in particular (Pagano & Volpin, 2001). They either change the "rules of the game" through regulation, or intervene on a case-by-case basis. We argue that both regulation and intervention by government may exert meaningful effects on MFI performance, and in either case, policy actions are likely to be motivated by government ideology. As mentioned above, left wing governments promote egalitarian income distribution through supporting programs that benefit their voters. In doing so, they often rely on mobilizing existing resources and avoid deep constitutional reforms because the latter may impede popular support by causing macroeconomic disequilibrium (Bédécarrats *et al.*, 2012). Microfinance institutions have already penetrated at the grassroots level in many low-income communities, and left wing parties may help these organizations to grow and serve their voters, particularly in rural and remote areas. After all, both microfinance and leftist political parties are pro-poor in nature because their mission is to improve the living conditions of the poor and excluded.

In many Latin American countries, left wing coalitions returned to the power after several decades of repressive dictatorship.[2] Left wing coalitions formed government in Venezuela in 1999; Brazil in 2002; Argentina in 2003; Uruguay in 2005; Honduras, Chile, and Bolivia in 2006; Ecuador and Nicaragua in 2007; Paraguay in 2008; El Salvador in 2009; and Peru in 2011. Despite their heterogeneity, these governments are largely committed to restructuring the society and economy, where the poor and marginalized gain importance

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