J. Finan. Intermediation 21 (2012) 181–202

Contents lists available at SciVerse ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Why government banks underperform: A political interference view

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ARTICLE INFO

Article history:
Received 12 August 2009
Available online 29 June 2011

JEL classification:
C23
G21
G28
G34

Keywords:
Political interferences
Government bank
Bank performance
Executive turnover
Election

ABSTRACT

This study proposes a *political interference hypothesis* to explain how political considerations depress the performance of government banks. We define political interference as a situation in which government bank executives are replaced within 12 months after the country's major elections (presidential or parliamentary elections). We classify political and non-political government banks as those that experience or do not experience political interference, respectively. The hypothesis firstly suggests that once government banks undertake political interference, their financial performance deteriorates. That is, political banks display the worst performance, followed by non-political banks and private banks have the best performance. Next, we posit that the impact of political interference is greater in developing countries than in developed countries. Finally, we hypothesize that the underperformance of government banks will be reduced if we remove political interference. By employing bank data from 65 countries from the period of 2003–2007, our hypothesis effectively explains why government banks in developed countries escape relatively unscathed, while those in developing countries suffer significantly.

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1. Introduction

This study examines whether or not government-owned banks (GOBs) underperform private-owned banks (POBs).[1] Empirical studies typically support this assertion regardless of profitability

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[1] Throughout the paper, the terms "government-owned banks" and "government banks" are used interchangeably. The terms "private-owned banks" and "private banks" are also used interchangeably.

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doi:10.1016/j.jfi.2011.06.003

measures, regions, and sample periods. For example, Mian (2003) found that government banks uniformly underperform private banks by examining 250 GOBs from 71 emerging economies. Iannotta et al. (2007), using an enlarged sample, found that government banks have lower profitability, loan quality, and higher insolvency risk compared with private banks. Furthermore, Cornett et al. (2008) found that government banks are significantly less profitable than private banks. Micco et al. (2007) also discovered government bank underperformance in less developed countries (LDCs)[2] but not in developed countries (DCs).[3] For simplicity, this study refers to the underperformance of government banks as the "GOB effect."

Several studies have provided explanations to account for the GOB effect. Sapienza (2004) proposed the social, agency, and political views to explain government bank under-performance. Both the social and agency views indicate that government banks are designed to maximize social welfare rather than profit, whereas the political view suggests that GOBs provide a mechanism for pursuing the goals of individual politicians. Beim and Calomiris (2001, p. 101) account for GOB inefficiency by identifying four similar factors, namely, multiplicity of goals, monopoly position, weak managerial incentives, and soft budgetary constraints. The multiple objectives of government banks also imply that such banks do not necessarily pursue profit maximization. Megginson (2005), along with other researchers, has presented similar explanations for the GOB effect.[4] These theoretical explanations clarify the reasons for the poor performance of government banks.

This study focuses empirically on one of the theoretical explanations: the impact of political interference on the poor performance of government banks. The difficulty of examining the effect of political interference on government banks lies in the lack of any operational definition for the concept. In the literature, election years are often used to measure political interference on GOBs (e.g., Brown and Dinç, 2005; Dinç, 2005; Micco et al., 2007). Sapienza (2004) also considered election years and ruling party to measure political interference. Our proxy of political interference, which has not previously been used, describes a situation in which executives of government banks are replaced within 12 months after major elections. Our major elections include presidential elections in countries with the president system and highest parliamentary elections in countries with the parliamentary system (see Persson and Tabellini, 2003, for the countries adopting either political system and Freedom House publications for the name lists of these countries). The proxy is referred to as "executive turnover" hereafter,[5] where the executives include the CEO or the chairman of the board of a bank. Our event periods also include election years and the executive turnovers after elections.[6]

To increase the sample size of executive turnovers during major elections, our sample includes 65 countries for the period of 2003–2007. For country-level information, we collect the dates of each country's major elections. With respect to bank-level information, we first identify banks in each country as government banks if the government ownership exceeded 20% of total shares, giving us a total of 226 government banks. Then, we search over the names of all directors and CEOs of these government banks from various sources, such as the Bankscope database, company websites, local newspapers, The Wall Street Journal, and the Factiva database.[7] The searching process is laborious and difficult because many banks only provide partial lists of board members, change their names or are acquired by other banks. Thus, we end up with about 80% of government banks for the period

[2] The terms "developing countries" and "less developed countries" are used interchangeably in this paper.

[3] Numerous studies have compared the performance of GOBs and POBs from the perspective of privatization. The GOB effect exists if GOB performance is improved upon privatization. Beck et al. (2005) examined a sample of Nigerian banks and found that overall performance improved in nine privatized banks, but their performance failed to surpass those of existing private banks. Boubakri et al. (2005) found that several performance measures, but not all, improved after privatization in developing countries. Furthermore, Weintraub and Nakane (2005) examined the privatization experience of Brazilian banks, and found that GOBs are significantly less productive than private banks.

[4] Megginson (2005) offered four reasons why GOBs are inherently inefficient. The four reasons are as follows. First, GOBs are created especially so that politicians can use them to benefit their own supporters at the expense of other social groups. Next, politicians who oversee GOBs cannot credibly commit not to bankrupt poorly performing banks. Third, managers of GOBs have weaker incentives than managers of POBs to manage their organizations effectively. Finally, government enterprises will be subject to less intense monitoring by owners.

[5] Our deep appreciation goes to the referee for his constructive suggestions for the hypothesis.

[6] Note that we exclude countries that are not deemed to have "free" or "partially free" elections (see data section for countries adopted). We appreciate the suggestion of one referee.

[7] Factiva is a new global database, which includes data from Dow Jones, Reuters, The Wall Street Journal, and so on.

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