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Banking system control, capital allocation, and economy performance ☆

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ABSTRACT

We observe less efficient capital allocation in countries whose banking systems are more thoroughly controlled by tycoons or families. The magnitude of this effect is similar to that of state control over banking. Unlike state control, tycoon or family control also correlates with slower economic and productivity growth, greater financial instability, and worse income inequality. These findings are consistent with theories that elite-capture of a country's financial system can embed "crony capitalism."

1. Introduction

The social purpose of the financial system is to allocate an economy's savings to their highest value uses (Schumpeter, 1912, 1942; Tobin, 1989; Aghion and Howitt, 1997; Wurgler, 2000). Economic growth thus correlates strongly with financial development (King and Levine, 1993a, b; Demirguc-Kunt and Levine, 1996; Levine, 1996; Demirguc-Kunt and Maksimovic,

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1998; Levine and Zervos, 1998; Rajan and Zingales, 1998; Beck, Levine, and Loayza, 2000; Levine, Loayza, and Beck, 2000; Beck and Levine, 2002). Rajan and Zingales (2003, 2004), noting the persistent financial underdevelopment of some economies and the full-scale reversal of financial development in others, posit the "elite capture" of countries' financial systems. This occurs if an elite – in this case, the already wealthy – attain sufficient control over an economy's financial sector to skew capital allocation in their favor. Elites come in many forms, but La Porta, Lopez-de-Silanes, and Shleifer (1999) show that most large firms in most countries are controlled by wealthy families, so linking "elite" to "business families" makes sense in this first pass investigation. The ensuing suboptimal capital allocation could substantially retard economic growth (Olson, 1965; Acemoglu, Johnson, and Robinson, 2005; Morck, Wolfenzon, and Yeung, 2005; Perotti and Volpin, 2007; Stulz, 2005; Fogel, Morck, and Yeung, 2008). Consistent with elite capture, we find less efficient capital allocation amid worse economy performance in countries whose banking systems are more predominantly controlled by wealthy tycoons or business families.

Caprio, Laeven, and Levine (2007) find that banks whose controlling shareholders have large cash flow rights outperform widely held banks. However, a wedge separates efficient bank governance at the bank and economy-levels (Saunders, Strock, and Travlos, 1990). For example, aggressively gaming deposit insurance or bailouts might raise bank shareholder value but harm the overall economy, and "excessive" bank CEO risk aversion (Kane, 1985; John, Litov, and Yeung, 2008) that depresses shareholder value might be socially preferable (Laeven and Levine, 2009). Furthermore, loans that finance technology, infrastructure, or other investments with positive spillovers (Jaffe, 1986; Nadiri and Mamuneas, 1994) may augment social welfare even if the borrowers default. Such externalities argue for state-control (Lewis, 1969), but empirical work shows "government failure" eclipsing any benefits (Dornbusch and Edwards, 1992; Krueger, 2002; La Porta, Lopez-de-Silanes, and Shleifer, 2002; Dinc, 2005). Nonetheless, these considerations make bank-level performance an unreliable indicator of economy-level implications of bank control.

The effect of tycoon or family control over banks on economy-level capital allocation efficiency is not prima facie obvious. Schumpeter (1912) argues that the prospect of founding a private dynasty motivates entrepreneurial effort. Shleifer and Vishny (1986) argue that large shareholders limit agency problems (Jensen and Meckling, 1976), and the most common controlling shareholders in most countries are wealthy families (La Porta, Lopez-de-Silanes, and Shleifer, 1999), and this is also true for banks (Caprio, Laeven, and Levine, 2007). Family control can be a feasible second best, absent legal systems that protect passive investors (Burkart, Panunzi, and Shleifer, 2003), because business families might resist predatory governments (Fisman and Khanna, 2004) or have valuable reputational capital and relationship networks (Khanna and Palepu, 2000; Khanna and Yafeh, 2005, 2007).

In most countries, wealthy business families use pyramiding, dual class shares, and other control enhancement devices (Bebchuk, Kraakman, and Triantis, 2000) to direct large "business groups", each containing many listed firms (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Morck, Stangeland, and Yeung, 2000) in many different industries (Khanna, Palepu, and Garten, 2000; Khanna and Palepu, 2000; Khanna and Rivkin, 2001; Khanna and Yafeh, 2005, 2007). Morck and Nakamura (2007) use Meiji Japan to illustrate how large family-controlled business groups might effect "big push" industrialization (Rosenstein-Rodan, 1943; Murphy, Shleifer, and Vishny, 1989) using "tunneling" (Johnson, La Porta, Lopez-De-Silanes, and Shleifer, 2000) to coordinate capital investment and orchestrate cross-industry subsidies, as an idealized central planner would. All else equal, these explanations point to more efficient capital allocation in countries whose banking systems are more thoroughly controlled by tycoons or business families.

In opposition to these stand several less beneficent explanations of family control over countries' banking systems. Family-controlled banks might pass from talented founders to less able heirs (Morck, Stangeland, and Yeung, 2000; Smith and Amoako-Adu, 2005; Perez-Gonzalez, 2006; Bennedsen, Nielsen, Pérez-González, and Wolfenzon, 2007), or might elicit reduced effort from employees who know top positions are reserved for family (Aronoff and Ward, 2000). Large shareholders can become entrenched (Morck, Shleifer, and Vishny, 1988; Stulz, 1988), extract private benefits of control (Nenova, 2003; Dyck and Zingales, 2004), and generate a host of agency problems (Bebchuk, Kraakman, and Triantis, 2000; Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2006). Banks in business groups can thus be exposed to vastly magnified agency problems (Bebchuk, Kraakman, and Triantis, 2000) that divert capital towards other group member firms (Almeida and Wolfenzon, 2006a) or losses into group banks when governments bail out banks but not other firms (Perotti and Vorage, 2008; Perotti and Volpin, 2007).

Families could use banks to limit capital to potential competitors, and this could motivate family control of banks regardless of whether or not this is efficient. There are other barriers to entry such as regulation (Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2002), tax favors (Gentry and Hubbard, 2000), subsidies (Krueger, 2002), and trade barriers (Krueger, 1974; Krueger, 2004). However, entrants' most critical need is arguably capital (Schumpeter, 1912; Levine, 1991, 1992; King and Levine, 1993a, b; Beck, Levine, and Loayza, 2000), so controlling the financial sector could let an established business elite protect its nonfinancial firms from entrants (Rajan and Zingales, 2003, 2004; Morck, Wolfenzon, and Yeung, 2005; Perotti and Vorage, 2008) more directly than alternative approaches, such as ongoing political rent-seeking (Krueger, 1974) or keeping relatives in key government positions (Faccio, 2006; Faccio, Masulis, and McConnell, 2006).

A dynamic banking system correlates with sustained prosperity (King and Levine, 1993a) and the ready financing of entrants (Beck, Demirgüç-Kunt, and Maksimovic, 2008), so elite capture of a country's financial system could plausibly be critically incomplete without control over its banks. We therefore focus on banks. All else equal, these explanations posit worse capital allocation in countries whose banking systems are more thoroughly controlled by tycoons or business families.

To explore these issues, we measure the fraction of each country's largest banks, listed and unlisted, that is ultimately