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SME performance in transition economies: The financial regulation and firm-level corruption nexus

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ABSTRACT

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Using a general equilibrium endogenous growth model we explain underperformance in the small and medium enterprise sector as an effect of corruption and non-competitive banking. Limited competition in the banking sector causes a high loan-deposit spread, worsens the initial effect of corruption, and depresses growth. Fostering bank competition, for instance, by allowing foreign bank entry, would be a simple solution to this problem, but frequently, authorities choose to hamper bank competition. Therefore, we explain the persistence of non-competitive banking as a result of governments' regulatory choice. If the government has a stake in the banking sector there exists a trade-off between current benefits from bank profits and future growth. Firm-level corruption affects intertemporal optimization and distorts the government's choice towards more restrictive regulation, i.e., less bank competition, even if the deciding institution itself is not corrupt. These results show that the two prominent problems for small and medium enterprises, corruption and finance, are mutually reinforcing. *Journal of Comparative Economics* **xxx** (xx) (2011) xxx–xxx. La Trobe University, Faculty of Law and Management, Edwards Road, Flora Hill, Victoria 3550, Australia; University of Paderborn, Warburger Straße 100, D-33098 Paderborn, Germany.

"The activity of branches of foreign banks in the Russian Federation should be limited... In essence it should be forbidden." Vladimir Putin (BBC News, 2005)

1. Introduction

For developing and transition economies, the growth of a private sector of small and medium enterprises (SMEs) is often regarded as a key to success. With higher efficiency than the large state-owned enterprises, the expansion of the private small business sector is expected to boost growth (McIntyre, 2001). In more advanced transition economies, such as Hungary and Poland, SMEs account for some 50% of GDP; however in other countries, e.g., Slovenia, Russia and

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Ukraine SMEs still account for less than 20% of GDP (Ayyagari et al., 2003). The two major reasons cited in the literature for this disappointing performance by the SME sector are bureaucratic costs, including corruption, and lack of finance.[1] Financial markets in transition economies are generally not sufficiently developed to match the financial needs of SMEs. Thus, apart from informal credits, banks can be regarded as the only source of finance for start-up firms. Bank competition and thus financial intermediation efficiency also varies significantly in the aforementioned countries. Limited bank competition is mirrored in the high net interest margin in a number of countries; 5% in Russia (EIU, 2008), 4% in Slovenia, 5% in Brazil, and 5% in Mexico (Barth et al., 2001). Competition can be stimulated easily by granting foreign banks access to the domestic market. (Claessens et al., 2001) However, numerous countries, among them Ethiopia, Algeria, China, India, Indonesia, Kenya, Pakistan, Sri Lanka, Thailand, Uruguay, Brazil, Egypt, Malaysia, Mexico, the Philippines, Poland, Romania and Russia, are actively hampering foreign bank access. (UNCTAD, 2006) This insistence on domestic bank protection represents a paradox, since the finance-growth literature emphasizes that efficient financial intermediation fosters growth,[2] and the empirical literature on transition economies does not suggest a negative impact resulting from foreign bank entry (World Bank, 2001; Barth et al., 2004; Clarke et al., 2006).

This paper solves the paradox by showing that a government's choice to limit bank competition is linked to firm-level corruption. Firm-level corruption diminishes the incentive to allow bank competition, e.g., via financial market liberalization, if the government benefits from banking sector activities. This result holds even if the deciding institution itself is not corrupt. Therefore, the two most significant problems for SMEs, finance and corruption, are closely connected.

Firstly, we extend a Romer-type endogenous growth model (Romer, 1987; Romer, 1990) to include corruption, bank-dependency, and oligopolistic banking.[3] Growth during the transition process is reflected by SME start-ups. Bribes diminish the profitability of SMEs and their ability to redeem start–up loans, which hampers the start-up process.[4] Oligopolistic banking decreases competition for deposits. The reduced return on deposits diminishes savings and thus available finance for start-ups and growth. This negative impact of market power on the availability of finance for SMEs is in line with most empirical analyses.[5] Existing theoretical literature combining endogenous growth and bank efficiency, e.g., King and Levine (1993), and Berthelemy and Varoudakis (1996), also highlight the importance of bank efficiency for growth.

The aforementioned literature, however, has not examined the government's regulatory choice to improve bank efficiency. To our knowledge, Amable and Chatelain (2001) and Amable et al. (2002) are the only papers that extend the finance-growth literature by introducing a benevolent government. In Amable and Chatelain (2001) public financial infrastructure investments[6] decrease the market power of spatially differentiated banks and increase deposit accumulation. The distortional finance of these investments through capital taxation diminishes the return on deposits, and thus the incentive to accumulate deposits. Therefore, the benevolent government "invests" an optimal amount to increase competition between banks, increase growth, and maximize welfare. While Amable and Chatelain (2001) contribution is well suited to explaining governments' efforts to increase bank competition, it does not explain why some countries fail to enhance competition by simply opening their financial sectors to foreign banks. Amable et al. (2002) introduce a trade-off between competitive efficiency in banking and financial stability, which explains why benevolent governments may choose to limit bank competition.

The related political economy literature offers "private" interests, e.g., maximizing government revenues or catering to interest groups, as an explanation (see, e.g., Shleifer and Vishny, 1994; Rajan and Zingales, 2003). However, it does not include interdependence with economic growth.

Secondly, we combine the insights of the political economy literature with the endogenous growth model to explain the government's (intertemporal) choice of banking competition. This enables new insights into the existing political economy of bank regulation, namely that firm-level corruption affects the government's choice to allow for limited bank competition.

The argument therefore is, if the government has a stake in the banking sector it benefits from limited bank competition. In a growth context, the opportunity cost of such a policy is a loss of economic growth. Since firm-level corruption diminishes growth potential, it also diminishes the opportunity cost of protectionism and weak competition in the financial sector. The result is that governments in economies with higher firm-level corruption will prefer a lower level of banking competition, even if the government itself is not corrupt.

The paper is structured as follows. The endogenous growth model with a focus on start-up problems of SMEs, caused by corruption and inefficient financial intermediation, is introduced in section two. Section three provides the solution to the model and discusses the comparative statics. Government policy motives in regard to bank competition are discussed in section four, and section five concludes the paper.

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1 See, e.g., Fries et al. (2003), World Bank (2005) and IFC (2009).

2 See Levine (1997, 2006) for reviews of the finance-growth nexus.

3 In regard to our focus on corruption and bank competition the chosen Romer-type model is identical to the so-called Schumpeterian growth models (e.g., Segerstrom et al., 1990; Grossman and Helpman, 1991; Aghion and Howitt, 1992), but provides a simpler structure.

4 See, e.g., United Nations (1990), Gould and Amaro-Reyes (1983), Mauro (1995), and Mo (2001) for adverse effects of corruption, and for an opposing view see, e.g., Leff (1964), Huntington (1968), and Barreto (2000).

5 See, e.g., Beck et al. (2004), Claessens and Laeven (2005). For an opposing view see, e.g., Bonaccorsi Di Patti and Dell'Ariccia (2004).

6 Financial infrastructure can be widely interpreted as any kind of infrastructure that fosters safe bank access (e.g., roads, phone network, depositor rights) and diminishes barriers to entry for banks (e.g., clearing facilities).