Now that we're getting a government owned investment bank what is the effect of government ownership of banks? [1]

Written by **Tim Worstall** [2] | Saturday 29 September 2012

Vince Cable seems to have got his idea of a state owned business investment bank approved. Which seems like a reasonable time to ask what the effects of such state ownership of banks and the banking system is. Or if you prefer, what is the effect of allowing politicians to direct bank lending?

Which is interesting because there's a new paper out which looks at just that [3]. There are two possible views here. One is that politicians are wiser than the accumulated wisdom of the markets (or perhaps their incentives lead them to make better decisions about capital allocation) and that therefore state owned banking will make everyone better off. Given that the part of the Spanish banking system, the *cajas*, that is bust and near to bankrupting the entire country is that part that was controlled by politicians makes this a tough argument to make. But perhaps that's just Spanish politicians. The other view, the "political" view, is that politicians will use state owned banks to reward their friends and buy votes. This will lead to even worse capital allocation than the market manages and make the future poorer than it needs to be. Having looked around the world the paper tells us that:

> We assemble data on government ownership of banks around the world. The data show that such ownership is large and pervasive, and higher in countries with low levels of per capita income, backward financial systems, interventionist and inefficient governments, and poor protection of property rights. Higher government ownership of banks in 1970 is associated with slower subsequent financial development and lower growth of per capita income and productivity. This evidence supports ?political? theories of the effects of government ownership of firms.

Ah, OK. So state owned banking is a very bad idea then. Something that should be clear to everyone *a priori*, even to the politicians rubbing their hands with glee at the idea of being able to buy support and votes. For while you, you near omniscient and incorruptible politician you, might indeed know better than everyone else how to allocate capital the same isn't true of your political opponents. Obviously it could not be for if it were you wouldn't be in the other party than them. But at some point the turns of political fortune are going to mean that they are going to get control of that lending and capital allocation.

This logic works whichever party you belong to: even if you do think that money should be allocated to cooperatives in order to stop the capitalists grinding the poor into the dust at some point the other lot will get in and allocate that same funding to the capitalists to grind the poor into the dust.

Or, as the paper says, we don't want state allocation of credit because it will lead to our children being poorer than they would be without it. For politicians make even worse decisions than bankers do if you could believe such a possibility.

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Links:

[1] http://www.adamsmith.org/blog/money-banking/now-that-were-getting-a-government-owned-investment-bank-what-is-the-effect-of

[2] http://www.adamsmith.org/taxonomy/term/5778

[3] http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/docs/publications/LaPorta%20PDF%20Papers-ALL/Govt%20Ownershi-Banks-All/Govt%20Ownership%20of%20Banks.pdf

[4] http://disqus.com/?ref_noscript

[5] http://disqus.com