

State-Business Relations

Topic Guide

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Executive summary

State-business relations are relations between the public and private sectors. They can take the form of formal, regular co-ordination or informal ad hoc interactions, and their scope can include the whole economy or target specific sectors, types of firms or policy processes.

State-business relations in low income countries are seen as a key determinant of **inclusive growth** (employment-generating economic activities that increase incomes and workers' productivity) and of **structural transformation** (shifts in economic structure to more productive activities and sectors).

Effective state-business relations can have a positive impact on economic growth by increasing the rate and the productivity of investment.

Characteristics of effective state-business relations are:

- **information flows:** the exchange of accurate and reliable information between business and government;
- **reciprocity:** the capacity of state actions to secure improved performance in return for subsidies or other forms of state support;
- **close consultation** and **coordination** between state and business.

Effective state-business relations are underpinned by:

- **credible commitment** of the state to policies, deals or arrangements, which can be ensured through both formal and informal institutions;
- a **stable policy environment**, which provides some security for investment by the private sector;
- **strong checks and balances** on government policies, tax and expenditure, which help to ensure that taxation policies and the provision of public goods are appropriate and of good quality.

Collusive or ineffective state-business relations are characterised by **rent-seeking** relations between business and the state. In such relations, elites use state agencies and business associations for their own benefits and not for collective goals of improved efficiency and economic transformation.

The emergence of effective state-business relations can be explained by:

- the presence of an **economic bureaucracy staffed by relatively competent individuals** who are insulated from the pressures of special interests;
- the presence of **strong national-level, and sectoral, business associations** representing the interests of business;
- the **economic ideology of the political regime**, and the **incentives** of political elites to foster collaboration with the private sector.

The most significant political economy barriers to the emergence of effective state-business relations in low income countries and fragile and conflict-affected states (FCAS) are:

- the lack of a **stable political settlement** in which informal relationships between political and economic elites are based on trust and reciprocity;
- **fragmented and weak organisational capacity of the private sector**, with a large part of the economic elite in non-competitive sectors;
- a **high degree of corruption** and its **lack of predictability**;
- the prevalence of **significant fragility and conflict**, which gives rise to capital leaving the country, weakening the private sector and leading to lack of durability in the political settlement;
- regulatory reforms that stress the creation of **formal 'arms-length' relationships** between the state and investors in weak governance environments, when **informal 'hand-in-hand' relationships** may be more effective.

Current approaches to improving the effectiveness of state-business relations are:

- support for **business associations**;
- **investment climate** reforms;
- **investment facilitation**;
- **public-private dialogue** mechanisms;
- the creation of **special economic zones**.

The literature provides the following **considerations for donors**:

- consider the need to move beyond economy-wide approaches to investment climate reform, or the need for Presidential Investors' Advisory Councils to tackle constraints that underpin specific sectors as well as the political factors that ensure these constraints persist;
- identify specific actors within the private sector that offer the greatest chances of delivering change, and engage with the specific forms of corruption and mismanagement they experience;
- look at how micro-climates for different kinds of firm are created and to what extent this enables 'deals' to happen, instead of focusing on wholesale reforms to improve the national 'investment climate', which in many contexts can be difficult;
- identify initiatives that may have little impact on the formal rules/investment climate but that have a significant impact on the deals environment and on investor expectations in ways that can help accelerate growth;
- work on both the supply and demand sides of state-business relations, tackling specific issues from both angles simultaneously, or identifying issues of mutual interest;
- strengthen the capability of the economic bureaucracy (for example, the ministries of commerce, finance and industry) and the organisational capacity of business associations.

1. Key concepts, ideas and debates

1.1 What are effective state-business relations?

State-business relations are relations between the public and private sectors. They can take the form of formal, regular, co-ordination or informal ad hoc interactions (te Velde 2013), and their scope can include the whole economy or target specific sectors, types of firms or policy processes. State-business relations may be 'passive', where the state does not engage with specific private sector actors but sets the formal and informal rules of engagement with the private sector. They can also be 'active', where the state may directly intervene in favour of certain firms, industries and sectors.¹

Characteristics of state-business relations that make them effective in promoting economic growth are (Haggard et al. 1997):

- **transparency:** the exchange of accurate and reliable information between business and government (Evans 1995);
- **reciprocity:** the capacity of state actions to secure improved performance in return for subsidies or other forms of state support (Doner and Schneider 2000);
- **credible commitment** of the state to predictable policies, deals or arrangements, which can be ensured through both formal and informal institutions (Sen 2013a);
- a **stable policy environment** provides a measure of security for private sector investment (Rodrik 1991, Harriss 2006);
- **strong checks and balances** on government policies, tax and expenditure help ensure that taxation policies and the provision of public goods are appropriate and of good quality (te Velde 2013);
- **close consultation, coordination and reciprocity** between state and business (Sen 2013b).

1.2 Why do state-business relations matter?

Synergistic or effective state-business relations are seen as a **key determinant of economic growth and structural transformation** in low income countries (Hausmann 2014). They are important in several areas of policy and practice, including macroeconomics, trade, industrial development, taxation, public expenditure, infrastructure, competition, anti-corruption, transparency and accountability, and private sector development.

There are several mechanisms through which state-business relations support economic growth. State commitment to basic policy can minimise uncertainties in the minds of investors and, by doing so, raise the rate of investment. Effective state-business relations can also lead to a higher rate of investment by creating an institutional environment where the state provides high quality public goods such as infrastructure, effective public administration (or the lack of corruption) and secure property rights (Sen 2013b). A well-organised private sector can clearly articulate priorities for public investment and can monitor the quality of such investment (te Velde 2009). Effective public administration and no expropriation of property rights of the private sector are more likely to occur with professionally-run and well-organised government agencies and through the direct and indirect pressures that business associations place on government officials (te Velde 2009). Effective state-business relations can also

¹ Examples of "passive" state-business relations are the setting up of a competition authority by the government to make sure that anti-competitive practices by any firm are discouraged, or the introduction of an investment climate reform measure such as reducing the days that it takes a firm to get a licence to start operations. Examples of "active" state-business relations are when the state provides subsidies to specific firms in return for their success in export markets or in creating employment in economically backward regions.

influence the productivity of investments by minimising the possibility of rent-seeking and collusive behaviour which may lead directly to unproductive economic activities (te Velde 2009).²

There are some suggestions that state-business relations can be part of the process of **democratising governance**, although evidence is limited. Effective relations imply a broader and deeper set of linked institutional arrangements that can enhance participation and accountability (Leftwich 2008). Moore and Hamalai (1997) suggest that robust and representative business associations strengthen civil society and intensify accountability and participation in relations between citizens and the state.³ Maxfield and Schneider (1997) argue that effective state-business relations that encompass a variety of private sector actors can contribute to the widening and deepening of the institutional environment in which economic and political decisions are made.

1.3 What is the state of the evidence?

Evidence drawn from statistical research and country case studies suggests that effective state-business relations are a **key determinant of economic growth and structural transformation**. However, the strongest evidence is mostly from East Asia, with more mixed results in other regions, and there is still a significant empirical challenge in addressing problems of measurement and attribution when many other factors can contribute to economic growth (Sen 2010).

Statistical research and country case studies have produced **a large body of evidence that effective state-business relations contribute to economic growth**, increasing both the rate of investment and the productivity of investment (Sen 2013b, te Velde 2013). Sen and te Velde (2009), using quantitative measures of effective state-business relations for 19 Sub-Saharan countries proposed by te Velde (2006), show that improvements in state-business relations between 1970-2004 led to higher economic growth. Similarly, Cali and Sen (2012), using quantitative measures of state-business relations for 16 Indian states proposed by Cali et al. (2011), show that improvements in state-business relations in these states between 1985-2006 have significantly increased economic growth at the subnational level in India.⁴

Using firm-level data from seven Sub-Saharan African countries (Benin, Ethiopia, Madagascar, Malawi, Mauritius, South Africa and Zambia) Qureshi and te Velde (2012) find that effective state-business relations enhance firm productivity. Ackah et al. (2013), Kathuria et al. (2013) and Hampwaye and Jeppesen (2014) find similar support for effective state-business relations enhancing firm productivity for Ghana, India and Zambia.

In Korea, developmental business-government relations established under the regime of Park Chung Hee since the early 1960s have been seen as the catalyst for the rapid economic growth that followed for the next few decades (Amsden 1989, Evans 1995). Many other case studies of state-business relations in developing countries have also consistently shown that improved state-business relations have contributed to better economic performance, either at the sectoral or economy-wide level (Johnson 1987, Maxfield and Schneider 1997, Abdel-Latif and Schmitz 2010, Page 2012).⁵

² Most of the literature on state-business relations, with its focus on the interactions between the state and the organised private sector, has confined the analysis of the relationship between state-business relations and economic performance to the formal sector. An exception is Kathuria et al. (2013), who examine the effect of state-business relations on the performance of formal and informal firms in Indian manufacturing in the 1990s and 2000s. This study finds that effective state-business relations improved firm performance in the formal sector but not in the informal sector.

³ An important part of democratising governance is the participation of women and minority communities in the decision-making process and in the exercise of their rights, which would involve the inclusion of gender and minority concerns in state-business relations (Bayes et al. 2001).

⁴ A macro-level study using time-series data that has found evidence of effective state business relations contributing to economic growth in Mauritius is Rojid and Seetanah (2013).

⁵ The country experiences with improvements in economic performance due to more effective state-business relations has been varied, with economic growth occurring through the growth of large firms as in the case of Korea (Amsden 1989) or with small and medium firms as in the case of Mauritius and Taiwan (Wade 1990).

The statistical evidence that relies on country level panels, and country case studies that attempt to establish causal evidence of effective state-business relations on economic growth, have an important limitation: there are concerns of reverse causality in understanding the relationship between state-business relations and growth. As economic growth occurs, state-business relations become more effective, and the bureaucratic capacity of the state improves, making it better able to provide the appropriate regulatory framework and key public goods necessary for private sector growth (te Velde 2006). Further, with economic growth, the private sector grows, diversifies, and is more capable of coordinating its relationship with the state (te Velde 2006). Thus, whether improvements in effective state-business relations cause growth, or are caused by it, remains a matter of empirical debate.

There is limited evidence on **how effective state-business relations emerge** in low income and FCAS country contexts. The literature is predominantly qualitative and theoretical. Most of the available case studies date from pre-2000, focusing on the factors that could explain rapid and sustained growth in East Asia. There are few case studies of state-business relations for African and South Asian countries. There is also limited evidence on the **success of donor interventions** in contributing to effective state-business relations. Analysis of the impact of donor interventions is difficult, as these cases do not lend themselves to experimental approaches, such as randomised control trials, and there is a lack of baseline data for most of these interventions. Evidence that effective state-business relations can contribute to **improving the wider governance environment** is limited.⁶

Box 1: Measuring effective state-business relations

Te Velde (2006) suggests that there are four elements in good state-business relations that can be measured:

- How the private sector is organised in relation to the public sector: this could be captured by the number of private sector business organisations in the country; the prevalence of these organisations in the overall community and the presence and length of existence of any umbrella organisation linking other businesses and associations together.
- How the public sector is organised in relation to the private sector: this could be captured by the presence and length of existence of an investment promotion agency (IPA) to promote business and the existence of other government institutions that interact with, and provide support for, the government.
- How the state interacts with business: this will be captured by the existence of active forums for public-private dialogue such as Joint Economic Councils.
- Mechanisms to avoid collusive behaviour: this will be captured by well-designed and functioning competition laws.

Applying these elements to 20 Sub-Saharan African countries for 1970-2004, te Velde (2006) finds that there has been an improvement in the effectiveness of state-business relations for all these countries since the mid-1990s. However, the rate of improvement has differed, with the most improvement seen in Botswana, Mauritius, Uganda and Mozambique and the least in Malawi, Zimbabwe, Madagascar, Zambia and Cote d'Ivoire.

⁶ Another weakness of the state-business relations literature is that the focus has been mostly on how the state can foster effective state-business relations, and there is limited knowledge of how the private sector can contribute to such relations, especially in low income country contexts.

1.4 Debates on state-business relations

While the importance of effective state-business relations in economic transformation and governance is widely recognised in the academic and policy literature, several issues of contention are unresolved.

Can collusive state-business relations become collaborative over time?

Collusive state-business relations are characterised by **rent-seeking** relations between business and the state, and the **capture** of state agencies and business associations by influential bureaucratic, political and economic elites (Leftwich 2008). When state-business relations are collusive, elites use state agencies and business associations for particularistic benefits and not for collective goals of improved efficiency and economic transformation (Maxfield and Schneider 1997). On the other hand, when state-business relations are collaborative (or effective), there is a synergistic and productive relationship between the government and the private sector (Maxfield and Schneider 1997). Both collusive and collaborative state-business relations are an outcome of close, and often personalised, interactions between the state and the business sector so, in practice, it is often difficult to distinguish between the two types of relations in many country contexts. Collaborative state-business relations can turn collusive if economic and political elites find larger gains in short-run rent-seeking, rather than through cooperation and coordination that delivers increased growth, innovation and capability development only in the long term.

Collusive state-business relations are difficult to change for three reasons (Leftwich 2008).

- **Institutional inertia** may hamper reform in a business association or a state agency which is poorly functioning or weakly organised, and there may be little incentive for key actors to change their behaviour.
- **Rent-seeking relations** between the state and the business sector may be retained by actors and groups who benefit and who may oppose change.
- **Associated institutional arrangements** such as a culture of bribe-taking among bureaucrats for granting licences may add resistance as stakeholders realise that changes in one institutional sphere may have knock-on effects in others.

Collusive state-business relations may become sustained or consolidated over time, and are highly resistant to external reforms (Chingaipe and Leftwich 2007). However, there may be opportunities for change when events occur which call into question existing institutional arrangements or allow the chance for them to be changed. For example, the global financial crisis of 2008 triggered far-reaching changes in the rules and regulatory frameworks governing the financial sector in developing and developed countries (Leftwich and Sen 2010).

Box 2: Are the boundaries between the state and business clear?

In many countries, the boundary between the state and the business sector is fluid. Politicians or political parties may own large private corporations, leading to a concentration of political and economic power, and making it difficult to distinguish between the public and private sector (Chingaipe and Leftwich 2007).

Informal collusive deals between politicians and private sector associations may also blur the distinction between these sectors, even though, formally, the state and business associations may have an arms-length relationship. In country contexts where the boundary between the state and business sector is not well defined, and open to capture by vested interests, both the organisations of the state and of the business sector may not have enough relative autonomy from each other, leading to the emergence and persistence of collusive state-business relations (Chingaipe 2013).

How should the state intervene in industrial policy?

Industrial policies target the dynamic development of a sector or sub-set of activities in the economy (te Velde 2013). Industrial policies are used by governments to alter the structure of production towards the sectors that offer the best prospects for sustained economic growth based on innovation and structural transformation. Industrial policies, through which the state creates (and withdraws) opportunities for profitable investments in certain activities, are shaped by state-business relations, and the ability of the public sector to work with the private sector for a common purpose, without being captured by the latter (Schmitz et al. 2013).

In the development policy literature, there is little consensus about whether state intervention through industrial policy can bring about improved economic performance (Lin 2012). Several countries in Latin America, Sub-Saharan Africa and South Asia, which have attempted different types of industrial policies during their import-substitution phases of development, have failed to spur economic growth or technological upgrading. In several cases, firms or sectors that received targeted support from the government in the form of subsidies or protection from internal and external competition have not developed the capability to innovate or to compete in world markets (Lin 2012).

On the other hand, in the case of East Asia as well as in countries such as Ireland and Mauritius, industrial policy has been largely successful in promoting economic growth and industrial competitiveness (Stiglitz and Yusuf 2001, Evans 2010, Chang 2006). In these countries, policy-makers have managed to direct the market towards dynamic and high growth sectors using clustering, subsidised credit, targeted technology and human resource development (te Velde 2013).

Effective industrial policy is an outcome of strategic collaboration between the private sector and the government in identifying the most significant obstacles to restructuring and how to remove them (Rodrik 2008). It is not about the *quantity* of state intervention but about its *quality*. Effective industrial policy, as has been followed in East Asia, has several common features (Rodrik 2008):

- The state does not target sectors or firms, but activities that have clear potential for building **firm capabilities** and providing **knowledge spill-overs, agglomeration benefits, technological upgrading** and **demonstration effects**.
- Incentives are provided only to new activities, rather than existing activities.
- There are clear benchmarks/criteria for success and failure.
- There are built-in sunset clauses, where the state withdraws support to favoured firms and sectors which are not performing as desired.
- The authority for carrying out industrial policies is vested in competent agencies.
- Implementing agencies are monitored closely by a principal with a clear stake in outcomes and political authority at the highest level.
- The agencies of the state carrying out promotion communicate clearly with the private sector.
- Promotion activities have the capacity to renew themselves so that the cycle of discovery of new products and processes continues.

Box 3: Key concepts in industrial policy

Agglomeration benefits: these are benefits that are obtained by clustering production in a defined geographical area. Firms benefit from agglomeration by having access to a pool of skilled workers and specialised inputs produced by other firms in the area, and to local public goods such as roads and electricity specially provided by the state.

Firm capabilities: the ability of the firm to integrate, build and reconfigure internal competencies such as managerial skills and technological acquisition for investment and growth of the firm.

Knowledge spillovers: these are the exchange of ideas that underpin the creation of new goods and new ways to produce existing goods.

Self-discovery: A process of learning and experimenting by firms and the government in what to produce, and how to produce them at the least cost or highest quality.

Technology upgrading: Investment in several dimensions of technology, such as computers, software, patents and innovation activities.

Processes versus policies

Policies and instruments for private sector development, such as competition policies and subsidies for investment promotion, are important for showing investors that the state has an interest in promoting private sector growth (te Velde 2014). However, in many low-income countries, such policies and instruments have been common for several decades but have not yet had the desired effect on economic development (Altenburg and von Drachenfels 2006). For example, many African countries have had competition policies in place since the 1990s, but these policies exist mostly on paper, with limited enforcement of laws and regulations prohibiting anti-competitive behaviour and restrictive trade practices (Sengupta and Dube 2008).

Such policies are less likely to be effective in country contexts where the public sector does not have capacity to implement these policies well, or where there is limited political will to implement them (Taylor 2012). Where the state's enforcement and implementation capabilities are weak, and where formal institutions function badly, an emphasis on reforming the processes of state-business interaction is more likely to encourage the state and business sectors to collaborate effectively – as may have occurred in Mauritius in the 1970s when it began to develop (Bräutigam and Diolle 2009, Leftwich and Sen 2010).

2. Drivers of success

While there is no single template for successful collaboration between the state and the business sector, the literature identifies the following elements of effective state-business relations, based on country experiences of successful collaboration.

2.1 Credible government commitments

Credible commitment of the state to policies, deals or arrangements is an essential attribute of effective state-business relations. Investment decisions may have large sunk costs – that is, the costs of certain investments cannot be recovered in full if the investment decision turns out to be less profitable than anticipated (Pindyck 1991). The state needs to make a commitment that it will not change its policies, or renege on deals and arrangements, in order to incentivise entrepreneurs to make investment and production decisions (Rodrik 1991). If the state were not to uphold its announcements and promises, it is very likely that investors would not believe the state in the future, and investment would suffer (Bardhan 2005).

Credible commitment can be obtained through both formal and informal institutions. Formal institutions include properly enforced laws that prohibit the expropriation of private property without just cause, and well-functioning courts that protect firms if the state engages in predatory behaviour.

Informal institutions are personalised relationships ('deals') between the agents of the state and the business sector that are repeated over time (Hallward-Driemeier and Pritchett 2015). If these deals are 'ordered' – that is, if deals negotiated between the state and business are reliably honoured – then informal institutions can provide the credible commitment necessary for investment to take place, even when formal institutions are missing or poorly functioning (Pritchett and Werker 2013, Sen 2013a).

The literature suggests that trust between the government and the private sector is an important contributing factor for the credibility of government actions and policies. While policies can be credible whether or not trust exists, policies and statements are more likely to be credible when there is prior trust (Rodrik 1997). Trust between business and government elites can reduce transaction costs and monitoring costs, diminish uncertainty, lengthen time horizons and increase investment (and policy fulfilment more generally) (Maxfield and Schneider 1997).

Trust in state-business relations is an outcome of repeated interactions between bureaucrats and politicians on the one hand and private sector actors on the other. It can occur both through formal mechanisms (such as periodic meetings of a Joint Economic Council) and informal mechanisms (such as through networks of friendship and contacts that state and private actors may have).

Box 4: Credible commitment in India's economic success

In the 1960s and 1970s, the Indian government followed a command-and-control regime with the private sector that led to collusion and rent-seeking behaviour, and had significant negative impacts on economic performance (Bhagwati 1993). There was an atmosphere of mutual distrust between the political and economic elites, and the government had a strong anti-business attitude (Kohli 2007).

With a change of government in 1980 and the return of Indira Gandhi as Prime Minister, the promotion of economic growth became the focus of the government's economic policy, leading to a growing alliance between the political and economic elites. As Kohli (2012: 30-31) notes: 'just after coming to power in January 1980, [...] Indira Gandhi let it be known that improving production was now her top priority. In meeting after meeting with private industrialists, she clarified that what the government was most interested in was production.'

Therefore, beginning in the 1980s, the Indian state clearly signalled to domestic capitalists its intention to commit credibly to an environment where private enterprise would be supported and growth-enhancing policies followed (De Long 2003, Rodrik and Subramanian 2004). This was reflected in changes in economic policies, such as the slow but steady liberalisation of import controls, especially on capital and intermediate goods.

The shift in the relationship between political and economic elites from one of mutual distrust to a more collaborative and synergistic relationship was further accentuated with the coming to power of Rajiv Gandhi in 1985. He took particular interest in modern sectors, such as information technology and engineering, and tried to bring new economic elites from these emerging sectors into the relationship that the political elite had with the business sector.

In addition, with the rise of non-traditional business groups in southern and western India, there was a growing diversification of business ownership, leading to a broadening of the political connectivity of the business elite (Mehta and Walton 2014). Private investment increased significantly since the mid-1980s, especially in new sectors such as information technology and pharmaceuticals and, within a decade, India was one of the fastest growing countries in the world (Sen 2013b).

2.2 Consultation, coordination and reciprocity

Successful collaboration between the state and the private sector needs close consultation, coordination and reciprocity. The private sector depends on bureaucrats and politicians for the successful design and implementation of policies, and the government depends on the private sector to ensure that private firms make the profitable investments that are necessary for growth and for policies to be sustained (Sen 2013b). Close consultation and coordination can help increase levels of trust, lower the costs for the state of monitoring private sector performance, and reassure the private sector that their interests and concerns are being addressed (Doner and Schneider 2000).

Reciprocity is an important element of effective state-business relations – if the state offers subsidies to the private sector, government officials need to know that the private sector will ensure that these subsidies are used productively (Harriss 2006). If subsidies are contingent on performance, the state should have the capability and commitment to discipline the private sector if it does not meet its targets, and the private sector should be aware that the government will behave in this way.

Box 5: The Joint Economic Council in Mauritius

The collaborative relationship between the state and the private sector has been seen as one of the key factors behind Mauritius' development success (Bräutigam and Diolle 2009). An important element of this relationship was the institutionalisation of the Joint Economic Council in 1970, which provided a forum for repeated – often public and high level – opportunities for meaningful consultation between the state and private sector.

The meetings in the Joint Economic Council allowed the private sector to express concerns about the government's overall economic policies. The Joint Economic Council was important in normalising expectations that the government-business relationship should be institutionalised, rather than a personal relationship between political leaders and heads of business, thereby minimising the risk of collusive and predatory engagement (Handley 2008).

Box 6: Government failure, market failure and coordination failure

Government failure occurs when excess government intervention in the economy leads to inefficiencies, which in turn lead to poor economic performance, or when there is an under-supply of critical public goods such as schooling, infrastructure and finance, and also under-provision of appropriate regulatory frameworks needed for private sector development, growth and structural transformation.

Market failure occurs when the markets inefficiently allocate goods and services.

Coordination failure occurs when certain desirable economic activities fail to take place due to lack of coordination among private sector associations, firms and state agencies.

Effective state-business relations can help prevent **government failure** by providing checks and balances on government policies, tax and expenditure plans. Regular sharing of information between states and businesses ensures that private sector objectives are met with public action and that the concerns of the private sector on distortionary effects of poor quality government intervention are taken into account when setting government policies (te Velde 2009). Good state-business relations also help ensure that the provision of public goods is appropriate and high quality.

Effective state-business relations can help prevent **market failure** by the joint action of the state and the private sector to raise collective efficiency in areas such as skill development of workers, technology policy, and upgrading quality of exports.

Effective state-business relations can help prevent **coordination failure** by providing an institutionalised mechanism to coordinate dispersed information between business associations and government departments, and by reducing policy uncertainty for the private sector.

2.3 Information sharing

Accurate, reliable information is a crucial element of successful collaboration between the state and business. Regular sharing of information between the state and businesses helps ensure that private sector objectives are met with public action and that local level issues are fed into higher level policy processes (Sen 2014). The greater the flow of information, the more accurately the government can predict the behaviour of the private sector in the case of a policy change, and the more likely that the policy will have the desired effect (Evans 1997, 2013). The private sector can identify constraints, opportunities, and policy options for creating incentives, lowering investment risks, and reducing the cost of doing business. The flow of information is also important in overcoming co-ordination failures in

investment decisions. Co-ordination failures can result from the high costs of collecting and processing information for new products, technologies and industries (Sen 2013a).

The exchange of information between the state and the private sector depends on the technical capacity of the state to compile and analyse the data, and the willingness of the private sector to share it (te Velde 2013). By investing in information-collection and processing, and by making information about new industries freely available to firms, the state can facilitate the introduction of new products and the move to new industries, and help bring about structural change and technological upgrading in the economy (Lin and Monga 2010).

Box 7: Information sharing between the state and the private sector in the Korean ‘growth miracle’

South Korea has been one of the fastest growing economies of the world since the 1960s. Central to Korea’s economic success has been the close and collaborative relationship between economic elites and political and bureaucratic elites, especially in the early decades of Korea’s industrial transformation (Evans 1997).

Private industrial elites were seen by the political elite as key collaborators in enabling industrial transformation, and as key sources of information regarding the feasibility of industrial goals. At the same time, the state provided information to the private sector about export opportunities, sectoral markets, labour market conditions and other issues that affected investment planning (Maxfield and Schneider 1997).

The close relationship between the state and the private sector allowed government officials to ensure that the right information was received by the right managers. These information flows shaped expectations about government intentions and enhanced credibility by giving investors signals about political commitments to certain courses of action (Doner and Schneider 2000).

2.4 A stable policy environment

Firms in low-income countries operate in an uncertain environment and frequently face risk and resource shortages (Kang et al. 2014). Uncertainty can have significant negative effects on investment, particularly when investment involves large irreversible costs and investors can delay the decision to invest until they have further information (Dixit and Pindyck 1994). A stable policy environment provides an enabling environment for the private sector to invest, by ensuring that there are no policy reversals that cannot be justified on economic grounds, and no flip-flops due to political pressures (Rodrik 1991, Harriss 2006). For example, if the government levies a high (but not unreasonable) rate of corporate tax on the private sector, keeps it stable, and uses the proceeds to finance high quality public goods (such as efficient administration and infrastructure), the predictability of this tax policy would be more effective in encouraging investment than tax reductions that are variable and unpredictable (Cali and Sen 2012).

2.5 Checks and balances on government

Strong checks and balances on government policies and on tax and expenditure help ensure that taxation policies and the provision of public goods are appropriate and of good quality (te Velde 2013).⁷ The design of effective government policies and regulations depends, among other things, on input from, and consultation with, the private sector. More efficient institutions and rules and regulations might be

⁷ Strong checks on tax and expenditure policies do not imply the absence of corruption. Rent-extraction and rent-sharing are often a feature of effective state-business relations (Khan 2006).

achieved through policy advocacy which could reduce the costs and risks faced by the private sector and enhance productivity (te Velde 2009).⁸

Box 8: Checks and balances on fiscal policy in Zambia

The engagement of interest groups in the budget-making process can generate relevant information that enables policy makers to make better choices on tax and expenditure. In Zambia, the government has put in place a mechanism through which individuals and interest groups can submit tax and expenditure proposals for inclusion in the national budget. This has become an important feature of the national budget-making process (Bwalya et al. 2011).

This mechanism has enabled different interest groups (including the private sector) to seek dialogue with the government on budget decisions by formally submitting and presenting their preferred fiscal policy positions to government at various stages of the budget process. The lobbying by interest groups can be formal, through budget submissions, or informal through avenues such as articles in the media.

By entering into a dialogue with the government on fiscal policy, the private sector has strengthened fiscal transparency and accountability in the government's taxation and expenditure policies (Bwalya et al. 2011). For its part, the government was responsive to formal consultations on the budget through the emergence of a stable "reform coalition", with the Zambia Business Forum as the key non-state actor in the coalition since the 1990s (Bwalya et al. 2011).

2.6 Which factors explain the emergence of effective state business-relations?

The literature identifies four enabling factors as the conditions under which effective state-business relations emerge:

State capabilities

Effective state-business relations often need the presence of an economic bureaucracy staffed by relatively competent individuals who are insulated from the pressures of special interests. Such bureaucracies are characterised by a high degree of well institutionalised and organisationally consistent career ladders, which bind staff to corporate goals while allowing them to acquire the expertise necessary to perform effectively (Evans 1995, 2010).

Effective bureaucracies are also characterised by autonomy and embeddedness. The **autonomy** of a bureaucracy, from the government and from the private sector, allows it to intervene selectively in favour of certain firms, sectors and industries and to provide both incentives to capitalists and to discipline them (Amsden 1989, Wade 1990). This also implies the ability of the state to let firms fail, when necessary, and for resources to be re-allocated from less productive sectors to more productive ones. The more a bureaucracy is insulated from politicians and the private sector, the more capable it is in taking difficult decisions to withdraw support for inefficient firms and to exit from industries where the country may no longer have a comparative advantage.

The **embeddedness** of a bureaucracy, in a dense web of interpersonal ties, can enable agencies and enterprises to construct joint projects at sectoral level with local capitalists (Evans 2012 p. 47). Avoiding capture and being able to discipline entrepreneurial elites were defining features of the 'embedded

⁸ It should be noted that formal checks and balances can be of value only when state actors are incentivised to follow formal rules.

autonomy' of East Asian developmental states, distinguishing them from less successful states in Asia and Africa (Evans 2012).

Effective bureaucracies have been crucial to the East Asian success stories by providing subsidies for technological upgrading and innovation to selected firms, and in closely monitoring them to ensure that they deliver greater export performance and capability development. The East Asian success stories suggest that technological dynamism in large conglomerates can co-exist with rent-sharing and high levels of corruption if the bureaucracy is capable of moderating the excesses of rent-extraction. The important feature has been the state-directed pressure of export success in an open economy that disciplines these excesses and keeps 'collusion-prone firms and bureaucrats on their toes' (Bardhan, in press, p. 63).

The structure and capacity of the private sector

The emergence of effective state-business relations needs the presence of a diversified and active private sector. This may occur through large conglomerates that have encompassing business interests in several sectors of the economy (as in the case of Korea and Thailand) or with a large number of small and medium firms that are present in the dynamic and growth-oriented sectors of the economy (as in case of Mauritius and Taiwan) (Maxfield and Schneider 1997).

The emergence of effective state-business relations is also related to the presence of strong peak and sectoral business associations representing the interests of business (Doner and Schneider 2000).⁹ Peak and sectoral business associations that are active, independent of the state and representative of the private sector in the region, can resolve many of the **collective action problems** that are inherent in developing countries, where most firms are small or medium sized and are unable to articulate their views and concerns to state agencies (Doner and Schneider 2000).

Such business associations can provide information on investment opportunities and potential problems to its members, invest in the training of member firms' workers, help in enforcing industry quality standards, and voice the demands of its members to industry ministries and state investment agencies (Cammett 2007). This can help reduce transaction and coordination costs and help members gain higher returns on investment.

Business associations can contribute to increasing the productivity of member firms by providing both market-supporting and market-complementing activities. Through market-supporting activities, business associations can strengthen the overall functioning of markets by supporting the provision of public goods such as electricity and roads, which are critical for productive investments (Doner and Schneider 2000). Market-complementing activities, on the other hand, address various types of market imperfections and involve 'direct coordination among firms to reconcile production and investment decisions' (Doner and Schneider 2000, p. 264).

Business associations¹⁰ that can play an effective role in promoting the interests of the private sector are usually well organised, well-resourced and staffed by professionals. They are also likely to be more effective when they represent a sizeable portion of the productive economy, and represent the range of business interests in the country, such as a strong peak association that speaks for all of its members, including small and medium enterprises, rather than a few large, politically connected firms (Bräutigam et al. 2002, Handley 2008). Qureshi and te Velde (2012) found that, in Zambia, joining a business association was particularly useful for small and medium firms (SMEs) as this allowed them to participate in state-

⁹ Peak business associations are organisations of the private sector that aim to represent all or most firms in the economy, independent of their industry affiliation or geographical presence.

¹⁰ See also section 4.4.

business relations, and voice their concerns, especially since they generally lacked the necessary financial and institutional means for effectively lobbying the government directly.¹¹

Dominant ideologies and elite incentives

The economic ideology of the political regime and the presence of incentives for political elites to foster a collaborative relationship with the private sector rather than a collusive one, are important factors for the emergence of effective state-business relations (Leftwich 2009). For example, in a comparative study of seven 'middle African' countries (Côte d'Ivoire, Ghana, Kenya, Malawi, Rwanda, Tanzania and Uganda), Booth (2012) finds that economic performance was strong in periods where there was a political regime that had 'a system to centralise the management of economic rents and orient rent generation to the long term' (p. 25). Under such regimes, the ruling elite had the disposition and capacity to use rents productively to enlarge the national economic pie, rather than obtaining the largest slices from it in the short term. Booth finds that all successful cases of growth in the seven countries had the following common features with respect to the dominant ideology and the political regime:

- a strong, visionary leader (often an independence or war-time hero);
- a single or dominant party system;
- a competent and confident economic technocracy;
- a strategy to include, at least partially, the most important political groups in some of the benefits of growth;
- a sound policy framework, meaning a broadly pro-capitalist, pro-rural bias.

In general, however, the type of political regime- whether it is a dominant party or multi-party system – is less important in explaining the emergence of effective state-business relations than the ideology of the key political actors, and whether there is a shared vision of the importance of growth oriented policies among rival political parties (Leftwich 2009).

¹¹ In addition to business associations, trade unions can also play an important role in fostering or hindering the emergence of effective state-business relations. In the case of South Africa, Seekings and Nattrass (2011) argue that it was the inability of the state to bring organised labour through their trade union representatives into a possible growth coalition with the business sector, that led to the lack of a developmental growth path post-apartheid.

3. Assessing state-business relations and the challenges of reform

3.1 Political economy barriers to the emergence of effective state-business relations

The literature on state-business relations in low income countries identifies six political economy barriers to the emergence of effective relations.

Political settlements and elite commitment to growth

A political settlement can be understood as ‘the forging of a common understanding, usually among elites, that their interests or beliefs are a particular way of organising political power’ (Whaites 2008, p.4). Khan (2010) argues that political settlements in low income countries are characterised by informal personalised relationships between political and economic actors that are often collusive and captured by powerful elites. Sen (2013a) argues that the acceleration of growth, after a prolonged period of stagnation or collapse, needs a stable political settlement comprising repeated informal relationships between political and economic elites based on trust and reciprocity.

If close relations between the ruling elite and productive entrepreneurs are based on mutual interests, the literature suggests that relations are likely to enhance growth. (Abdel-Latif and Schmitz 2010, Whitfield and Therkildsen 2011). However, the literature does not explain the conditions under which effective informal relations, based on mutual interests, are likely to emerge and be sustained.

There is limited evidence on whether political settlements also need to be inclusive for collaborative state-business relations to emerge. Growth accelerations, where they have occurred, have been underpinned by stable political settlements that were not necessarily inclusive (Hickey et al. 2014). For example, Korea in 1962, Indonesia in 1967 and Thailand in 1958 witnessed large accelerations in economic growth, where growth was sustained for several decades. Sen (2013a) argues that these growth accelerations occurred under authoritarian political regimes that were not inclusive for much of the period of rapid growth.

The literature emphasises that the long-term commitment of ruling elites to stable informal relations with economic actors is a precondition for collaborative state-business relations (Khan 2010, Buur and Whitfield 2013). This is less likely to emerge in FCAS or in low income countries with weak governments. In these contexts, it is harder for ruling elites to look beyond their immediate political survival and strategies. Short-term political survival imperatives constrain the ability of ruling elites to commit credibly to deals with economic actors that are likely to be durable and conducive to long-term investments (Buur and Whitfield 2013).

The nature of the private sector

The divergent interests of the private sector with respect to its demands of the state, depending on the nature of the economy, suggest that **the private sector should not be viewed through a single ‘lens’** when assessing the effectiveness of state-business relations.

Pritchett and Werker (2013) argue that different economic sectors offer different incentives to the development of effective state-business relations. **Non-competitive sectors** include natural resource based industries, where firms may have paid a low price to acquire rights to resources (such as diamonds), and sectors such as utilities and telecommunications where there may be regulated, or natural, monopolies. **Competitive sectors** are those where there are no excess profits, such as:

- export-oriented manufacturing;
- domestically oriented manufacturing where the industries are competitive;
- subsistence and smallholder commercial agriculture;
- service sectors such as retail trade.

Pritchett and Werker (2013) and Werker (2014) suggest that firms in non-competitive sectors would attempt to have close and collusive relations with the state to ensure that their sectors are closed to the entry of possible competitors. In contrast, firms in competitive sectors would push for an open and transparent relationship with the state.

Fragile states are typically characterised by small non-competitive economic sectors, so collusive relations between firms and the state are likely to emerge more in fragile states than in non-fragile states (Peschka 2011). Collusive state-business relations are also likely to be present more in resource-rich low and middle income economies (Robinson et al. 2006), as well as in countries where there are a few large politically connected firms (whether domestically owned or multinational corporations) in protected industries, and where the rest of the private sector is fragmented and populated by small firms with limited political voice (Haggard et al. 1997).

The nature, extent and predictability of corruption

Corruption is a serious impediment to private sector development (DFID 2015). It is the second most significant barrier to doing business (after access to financing) in two-thirds of DFID partner countries (World Economic Forum 2012). Corruption can create additional costs for firms that already face high costs of production in low income country contexts where input and product markets may not be well functioning (Fisman and Svensson 2001). Evidence suggests that corruption can have a negative impact on private sector growth (DFID 2015). However, there may also be positive impacts by reducing inefficiencies in contexts where bureaucrats are able to engage in corruption (Méon and Sekkat 2005).

Whether the prevalence of corruption contributes to ineffective state-business relations depends on the nature, extent and predictability of corruption (DFID 2015). For example, corruption among customs officials may lead to less rent-seeking behaviour among firms than corruption among regulators (DFID 2015). Predictable corruption, where state officials can offer 'ordered deals' to private investors in return for bribes, can be less damaging to the private sector than corruption that is unpredictable and where deals are 'disordered' – that is, where state officials renege on or cannot deliver the deals they offer to private investors (Pritchett and Werker 2013).

Predictable corruption is more likely in country contexts where rent-seeking is centralised, usually under a dominant party that is in power and has the authority to maintain the deals (Booth 2015).¹² Corruption is more likely to be unpredictable in FCAS country contexts, where the state has limited reach or authority to maintain deals (Peschka 2011).

¹² For example, Larsson (2006) argues that the disorganisation of corruption in Russia versus the organisation of corruption in China can help explain their divergent growth paths. In a survey of investors from emerging economies, Gómez-Mera et al. (2014) find that investors from these economies value political stability and transparency more than control of corruption and risk of expropriation in the host country.

Box 9: Corruption and economic growth: the cases of Korea and Thailand

Corrupt deals between politicians and the business sector were evident in Korea for much of its early growth period until the 1980s with political elites taking ‘massive donations from the *chaebol* in return for loans and sweetheart deals’ (Kang 2002). Personal ties between business and political elites and the system of exchanging bribes for political favours underpinned informal institutions of credible commitment in Korea all through the 1960s and 1970s. This was crucial for Korea’s success in the early stage of growth, in a context where the rule of law in Korea was vague and seldom enforced (Kang 2002).

Another example of the role of corruption in providing the basis for a collaborative relationship between political and economic elites in early stage growth acceleration is provided by Thailand. Thailand’s growth acceleration in 1958 coincides with the seizure of power by Field Marshall Sarit Thanarat in 1957. Doner and Ramsay (1997) argue that under the Sarit regime, there were strong clientelist relations between Chinese entrepreneurs and local Thai officials based in sectoral Ministries such as Agriculture, Industry and Commerce as well as the agency established by Sarit to attract foreign capital – the Board of Investment. These patron-client networks were growth-enhancing as they discouraged capital flight by encouraging Thai entrepreneurs to invest in patronage, and were also competition-inducing: ‘With fragmented political patrons eager to obtain extra-bureaucratic funds, clientelism facilitated a constant flow of new private sector claimants on state largesse and thereby weakened tendencies towards the more common result of clientelism – monopoly cronyism’ (Doner and Ramsay 1997, p. 250).

Fragility and conflict

In FCAS country contexts, the impact of conflict, violence and prolonged fragility is particularly damaging to the private sector (Peschka 2011). The literature suggests that foreign and local investors are more likely to leave the country in situations of conflict and state fragility, undermining the strength of local business associations that could help prevent the slide into further conflict (Peschka 2011). Putzel and Di John (2011) argue that in the FCAS context, political settlements do not provide an incentive structure that promotes productivity growth in the main economic sectors, though they can be instrumental in maintaining political stability and state resilience (e.g. as in Zambia). Durable political settlements that can lead to deals between political actors and economic actors that are ‘ordered’ are less likely to occur in FCAS contexts (De Waal 2014).

However, in the East Asian context and in Mauritius, systemic vulnerability – defined as a situation of extreme geopolitical insecurity and severe resource constraints – created strong incentives for economic performance and for the kind of close ties between governments and business that underpin more effective policies (Doner, Ritchie and Slater 2005, Bräutigam and Diolle 2009). Three conditions were seen as necessary for systemic vulnerability to operate in these country contexts: ‘i) the credible threat that any deterioration in the living standards of popular sectors could trigger unmanageable mass unrest; ii) the heightened need for foreign exchange and war material induced by national insecurity; and iii) the hard budget constraint imposed by a scarcity of easy revenue sources’ (Doner, Ritchie and Slater 2005). In the case of FCAS countries, this implies that it is possible that the presence of systemic vulnerability can lead to the emergence of effective state-business relations, though this would also depend on the stability of the political settlement and the political leadership’s commitment to long-run economic development (Leftwich 2009).

Regulation

A transparent regulatory environment where with low business costs is often seen as being conducive to effective state-business relations (Sen 2013c). Improvements in the regulatory environment can reduce the uncertainty that investors face and increase the credibility of the government’s policy intentions and actions for the private sector (Moore and Schmitz 2008). Yet evidence about whether regulatory reform

is an important enabling factor for effective state-business relations is mixed (Altenburg and von Drachenfels 2008). Moore and Schmitz (2008) argue that that regulatory reform that stresses the creation of formal 'arms-length' relationships between the state and investors in weak governance environments is not likely to be as effective as more informal 'hand-in-hand' personalised relationships based on trust and reciprocity. However, the literature does not provide clear guidance on whether 'hand-in-hand' informal relationships can become a core component of effective state-business relations, as in many low-income countries such relationships tend to become collusive and subject to rent-seeking behaviour (Chingaipe 2013).

Privatisation and the role of state-owned enterprises

The role of state-owned enterprises in contributing to effective state-business relations is unclear. A large presence of state-owned enterprises can inhibit private sector development, and may cause the state to favour its own enterprises for preferential treatment, to the detriment of private sector firms (World Bank 2005a).¹³ On the other hand, a programme of privatisation can lead to the capture of large parastatals by a few powerful economic actors who may form an oligarchy, leading to the creation of more collusive state-business relations (Fortescue 2006, Bardhan, in press). Privatisation may also lead to adverse effects on women and minority communities if the process leads to a weakening of their rights to land and other assets, as resources are transferred from public to private ownership (Lastarria-Cornhiel 2001). Privatisation can also contribute to instability if public sector employment has been used as a mechanism for dispensing patronage to supporters of the ruling elite as a way of obtaining political support. If privatisation leads to large job losses in parastatals, opposition to the ruling elite may emerge, leading to conflict (Acemoglu and Robinson 2008).¹⁴

3.2 What do business and the state see as common bottlenecks?

There are few systematic surveys of what either the private or public sectors see as bottlenecks to effective state-business relations. Most of the evidence on the perceptions held by the private sector comes from the Enterprise Surveys of the World Bank. Lack of electricity and lack of finance are seen as the most important constraints to doing business in 10 out of the 22 FCAS countries covered by the surveys (World Bank 2015). Other major issues are political instability, competition from the informal sector and corruption (Peschka 2011). Lack of finance is a major constraint for small firms in other low income countries, along with taxes and corruption (Bloom et al. 2014). Limited access to government decision-makers, and to information about regulations, and about markets, are constraints highlighted by surveys of small firms in low-income countries on the value of services provided by business associations (Qureshi and te Velde 2013). There are no equivalent surveys of public sector actors on what they see as the constraints on effective state-business relations.

¹³ As the World Bank (1992) notes, most privatisation success stories come from high-income and middle-income countries. Privatisation is easier to launch and more likely to produce positive results when the company operates in a competitive market, and when the country has a market-friendly policy environment and a good capacity to regulate. The poorer the country, the longer the odds against privatisation producing its anticipated benefits, and the more difficult the process of preparing the terrain for sale.

¹⁴ An example of this is from the enactment of structural adjustment policies in Africa in the 1980s. Here, attempts by the International Financial Institutions to induce downsizing of the public sector, for example by closing down loss-making parastatals may have played an important role in creating civil war in Sierra Leone and Liberia as political elites used public sector employment as a means to redistribute rents to opponents or potential opponents as a way of obtaining political support (Acemoglu and Robinson 2008).

4. Approaches to improving the effectiveness of state-business relations

4.1 Investment climate reforms

Investment climate (IC) reforms are regulatory reforms that promote private sector growth by reducing bureaucratic obstacles, costs and time constraints to doing business and improving the efficiency of legal institutions (World Bank 2015). IC reforms may be particularly beneficial for small firms, which face the highest costs of doing business relative to their sales (World Bank 2015).

The evidence on whether IC reforms lead to private sector development and more effective state-business relations is weak and contested (Cox 2008, Aboal et al. 2012, Booth 2014). For example, Bah and Fang (2015) use a model-based approach to show that businesses in Africa lose large shares of their sales due to government regulations, poor infrastructure, corruption and crime, leading to lower output and productivity growth. On the other hand, Altenburg and von Drachenfels (2006) argue that IC reform is based on unrealistic assumptions and is not backed by sufficient empirical evidence.¹⁵ Moore and Schmitz (2008) argue that traditional IC reforms are undertaken with the assumption that there are impersonal arms-length relationships between state and business actors. In reality, in most low income countries, synergistic state-business relations tend to be personalised and ‘hand-in-hand’. They argue that reconstructing the relationship between investors and government, through interaction and experiential learning, rather than reforms of formal rules and regulations, are likely to yield higher returns in low income countries, as was witnessed in China in the 1980s, where informal institutional change preceded formal institutional reform.

The evidence on what works best in IC reform is limited, especially in fragile and conflict-affected states which are characterised by institutional and regulatory vacuums and/or extremely weak business environments. The evidence on donor-supported IC reforms is mixed and qualified (Manuel 2015). The evidence suggests that IC reform is not sufficient for growth but is broadly necessary, and reforms need to target genuinely binding constraints to have an impact (Besley 2015). This may be due to ‘isomorphic mimicry’ where donors drive through institutional reforms that produce systems with the appearance of ‘best practice’ solutions but without the underlying institutional reform that produces real improvements in capacity (Andrews 2013).

There is not sufficient evidence that alternate approaches to IC reforms such as ‘Doing Development Differently’¹⁶ (*The DDD Manifesto 2014*) have had greater success in private sector development and in contributing to the emergence of effective state-business relations. More evidence is needed on how IC reforms can contribute to effective state-business reforms, which reforms work best, and which parts of the private sector benefit most.

¹⁵ An important but under-studied aspect of investment climate reform is the integration of gender issues into the investment climate agenda. This can reduce gender barriers, unleash the untapped productive potential of women, and broaden both the economic impact and sustainability of policy interventions (Simavi and Manuel, 2010).

¹⁶ The core principles of the “Doing Development Differently” approach are a) locally identified and defined problems provide the entry point (not large scale institutional reform), b) solutions and results are not “locked in” at the beginning of the programme, but instead are based on continuing, strategic political economy and context analysis, c) solutions are developed iteratively which can be adapted (or abandoned if unsuccessful), and d) solutions are not based on “best practice” from developed countries but instead “best fit” for the country context (*The DDD Manifesto 2014*).

Box 10: New approaches to designing IC reforms and commercial justice programmes

Uganda

The DFID Legal Assistance for Reform (LASER) programme attempted a set of reforms in Uganda's commercial justice system. The entry point for engagement with the government was not large-scale institutional reform, but through a key initiative identified through *purposive muddling*: the Judiciary's piloting of small claims procedures. This initiative had the potential to significantly improve access to commercial dispute resolution for micro, small and medium size enterprises. LASER personnel on the ground are working incrementally – first helping the judiciary to develop an M&E system for this initiative; then using this as a platform to work iteratively with local stakeholders to identify commercial justice problems for businesses and potential solutions; and then eventually, and if appropriate, to suggest a role for DFID Uganda to invest funds.

Mozambique

During an eight-month process, a small team from Harvard University facilitated a local justice sector stakeholder reform group to pinpoint and close gaps in capacity. Inter-agency tensions in the justice sector that had undermined the previous donor-supported project became identifiable and were, in some cases, addressed. Major data gaps and steps to close them were also identified, including 'unlocking' significant donor funds. Challenges experienced reinforced the importance of doing reforms step by step and constantly paying attention to legitimacy and authority issues. The result was to yield more potential functionality than had been achieved through five years in the preceding donor-supported project.

Source: Manuel (2015)

4.2 Special economic zones

Special Economic Zones (SEZs) are geographical spaces in which firms are provided with regulatory or financial incentives. Typically, in a SEZ, 'the rules of business are different from those that prevail in the national territory. These rules principally deal with investment conditions, international trade and customs, taxation, and the regulatory environment; whereby the zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory' (Farole, 2011, p. 23). SEZs aim to encourage particular types of economic activity by improving the investment climate (Conway 2015).

SEZs can be broadly classified into four categories:

- **export processing zones** facilitate manufacture of goods for export, are small in size, and offer supporting infrastructure and services;
- **free trade zones** facilitate international trade in both goods and services, are small in size and are physically separated from the rest of the economy;
- **freeports** are large scale and cover a range of both domestic and international activities;
- **enterprise zones** cover a range of economic activities within deprived areas, often in remote regions.

SEZs are normally established with the aim of achieving one or more of the following policy objectives:

- **attracting foreign direct investment (FDI)** – almost all SEZs aim, in part, to attract foreign direct investment;
- **supporting export development** – For countries which have adopted protectionist import substitution policies, SEZs permit a country to develop and diversify exports while keeping protective barriers intact;

- **acting as experimental laboratories for the application of new policies and approaches** – in some countries, such as China, foreign direct investment, legal, land, labour, and pricing policies were introduced and tested first within SEZs before being extended to the rest of the economy.

There has been a large increase in the number of SEZs, with over 3,500 export processing zones employing 66 million people across 130 countries (UNIDO 2009). The majority of SEZs are in Asia and Latin America, where they were first introduced in the 1970s. They are less widespread in Africa, but increasing (UNIDO 2009).

Assessment of SEZ performance is difficult because of a lack of sufficiently accurate longitudinal performance-related data. In addition, there is a strong interaction between SEZs and the wider investment climate, making it difficult to isolate the effects of SEZs. Evidence for the success of SEZs is reliant on country case studies which are highly context specific.

Quantitative empirical research shows that many SEZs have been successful in generating exports and employment, and come out marginally positive in cost-benefit assessments (Jayanthakumaran 2003, Monge-González et al. 2005). Most examples of successful SEZs are from East Asia, where SEZs have facilitated industrial development and technological upgrading. SEZs in China provided a platform for attracting foreign direct investment and not only supported the development of China's export-oriented manufacturing sector, but also served as a catalyst for sweeping economic reforms that later were extended throughout the country (Farole and Akinci 2011). In Latin America, countries such as the Dominican Republic, El Salvador, and Honduras used free trade zones to take advantage of preferential access to U.S. markets and have generated large-scale manufacturing sectors in economies that previously were reliant on agricultural commodities. In the Middle East and North Africa, SEZs have played an important role in catalysing export-oriented diversification in countries such as Egypt, Morocco, and the United Arab Emirates.

However, using case studies from Africa, Asia and Latin America, Farole and Akinci (2011) show that many SEZs have resulted in industries taking advantage of tax breaks without producing substantial employment or export earnings. Moreover, although many export-processing zones have been successful in attracting investment and creating employment in the short-term, many have failed to remain sustainable when labour costs have risen or when preferential trade access is lost. There is limited evidence that SEZs have been successful in sub-Saharan Africa, with the exception of Mauritius, where the SEZ was a central policy tool supporting a highly successful process of economic diversification and industrialisation (Farole and Akinci 2011). SEZs have also had limited success in South Asia, with the exception of Bangladesh in ready-made garments exports (Khan 2010, Jenkins et al. 2014).

Moberg (2015) argues that the success of SEZs depends on the nature of state-business relations in the country. Where state-business relations are collusive or rent-seeking, SEZs may be set up or function as a mechanism of rent-extraction of political elites from foreign and domestic private firms. On the other hand, where state-business relations are collaborative, political elites have an incentive to provide high quality infrastructure and well enforced and streamlined regulatory procedures to firms located in SEZs to enable them to be successful exporters. Moberg suggests that SEZs in India have not been successful as local elites considered these SEZs as a way of extracting bribes and were not interested in their long-term development. However, SEZs in China have been largely successful as the political decentralisation that occurred in the reform process led to local governments having an interest in the success of SEZs as they gained a share of the tax revenues from the firms' profits.

Box 11: How did the state of Penang in Malaysia become a major export hub?

Penang, a state in northwest Malaysia, is a pioneer in the establishment of free trade zones in East Asia and has become a major export hub for electronics. After consolidating its position in manufacturing trade by engaging in low-end activities and final assembly within production networks in the 1980s and 1990s, it has now moved into several electronics-related product lines with high-growth prospects.

Committed political leadership contributed to the emergence of a synergistic relationship between the state and multinational corporations that was critical for the state's success in exports and technological upgrading. The most important initiative of the Penang government in fostering collaborative state-business relations was the creation of the Penang Development Corporation (PDC). This was the principal development agency of the government, but it was able to maintain independence from the bureaucracy, which allowed it to be the key coordinating agency for the formulation and implementation of an export-oriented industrialisation strategy, with a clear focus on electronics as the leading sector.

Key components of industrial policy were a strong emphasis on cluster development, the encouragement of close links between multinationals and local firms, and the effective use of industrial estates for infrastructure development. An innovative land bank policy allowed market acquisition of private land, and a skill development policy through the Penang Skill Development Centre helped ensure that skill shortages did not hamper the progress of industries up the value-added ladder.

Crucial to the role of the PDC in creating an export hub in Penang were the proactive attempts to develop links between local firms and multinational affiliates, and to address emerging bottlenecks in skills development and infrastructure.

Source: Athukorala (2014).

4.3 Presidential investors' advisory councils

Presidential investors' advisory councils (PIAC) were created by the presidents of Ghana, Tanzania and Senegal in 2002, and in Mali and Uganda in 2004. Subsequently, councils were set up in Mauritania and Benin. Ethiopia launched a Public-Private Consultative Forum – loosely modelled on the PIAC – in 2010. The PIACs were supported by the World Bank and IMF, and were linked to the World Bank's private sector development and investment-climate reform programmes. The main purpose behind the establishment of the councils was to enable presidents and governments to talk with experienced business leaders to identify obstacles to investment, generate recommendations for concrete action, and accelerate continuing policy reforms to improve the overall investment climate (World Bank 2005b).

A World Bank (2005b) impact assessment found that PIACs have had a positive impact on private sector development by reforming many investment-climate issues. However, there was less evidence of progress on more complex strategic priorities, such as identifying and promoting sources of growth. In a study of PIACs in Ethiopia, Senegal, Tanzania and Uganda, the African Development Bank (2012) found significant variation in effectiveness. Uganda was a clear success due largely to the care taken to design its structure and processes, and to a firm commitment from the President to act on its recommendations. The PIAC secretariat was located in the Ugandan Investment Agency, which enjoyed a solid reputation for competence with the private sector. Representation of the private sector was extended beyond a small number of big businesses to small and medium enterprises and business associations (World Bank 2005b).

Page (2014) identified four reasons for the lack of effectiveness of PIACs as a mechanism to implement industrial policy in Africa, compared with their more successful counterparts in East Asia:

- a marked lack of enthusiasm for the councils from top political leadership, except in the case of Uganda;
- a lack of focus on identifying industry, sector and firm specific constraints to growth, and a preoccupation with an economy-wide agenda for investment climate reforms, influenced by the World Bank's own agenda around private sector development;
- a lack of a systematic means of assessing the impact of the council's decisions on firm performance, investment, and growth; and
- a limited track record in experimentation and innovation, which were essential to the success of the public-private forums in East Asia. This was partly due to the fact that the councils' agendas were mostly set by multilateral donors which were pursuing their own policy reform agendas, and partly due to the bias in the membership of the councils to large investors.

4.4 Business associations

Business associations include **peak business associations** that represent a large segment of private firms in the country, **chambers of commerce** and **business membership associations** that represent smaller groups of businesses, and **sector associations** that represent firms in specific sectors or industries.

The evidence on the success of business associations in contributing to effective state-business relations in low income country contexts is limited, with most evidence drawn from the growth successes of East Asia (Maxfield and Schneider 1997, Doner and Schneider 2000). Using case-studies from Mauritius, Zambia and Zimbabwe, Bräutigam et al. (2002) argue that effective state-business relations were more likely to emerge when the business association broadly represented the range of business interests in the country, had technical capacity, credibility and a resource base, and when the government and business associations had institutionalised, regular, consultations. However, they also suggest that the sustenance of effective state-business relations in low income country contexts also depends on other factors such as state leadership, ideological commitment to growth and state capacity. Taylor (2012) suggests that, where good policies towards the private sector have emerged in the African context, it has not been through these East Asian-style growth coalitions, but argues that it has occurred through specific actions taken by a committed pro-business leadership, as in the case of Rwanda and Zambia. However, such improvements in the business environment that depend on the actions taken by specific political leaders are unlikely to be sustained in the long term (Taylor 2012).

4.5 Public-private dialogue mechanisms

Following the Fourth High Level Forum on Aid (HLF-4) held in Busan in 2011, there has been increasing emphasis on public-private dialogues (PPDs), where 'consultation with the private sector in the elaboration of national and sector plans is seen as a prerequisite for broadening country ownership of the development process' (Herzberg and Nicod 2013). PPDs come in many forms: they can be structured or ad hoc, formal or informal, and wide-ranging or focused on specific issues (Herzberg and Wright 2013). The main potential benefits of PPDs are seen to be:

- facilitating investment climate reforms by supporting champions for reform, creating momentum and accelerating the reform process;
- promoting better diagnosis of investment climate problems and design of policy reforms;
- making policy reforms easier to implement;
- promoting transparency and good governance; and
- building an atmosphere of mutual trust and understanding between the public and private sectors (Herzberg and Wright 2013).

The literature suggests that PPDs, when done well, can give stakeholders a voice which they otherwise would not have, and give governments a sounding board which can improve the quality of policy-making (Herzberg and Wright 2013).¹⁷ However, if PPDs are not sufficiently transparent and broad-based, they can reinforce vested interests and create incentives for rent-seeking behaviour (te Velde 2013).¹⁸

Box 12: Charter for good practice in using public-private dialogue for private sector development

The charter sets out the following principles:

Mandate and institutional alignment: A statement of objective is helpful for clarity. A formal or legal mandate can be an important help in some political and economic contexts, but mandates are never sufficient to establish good Public–Private Dialogue (PPD). Wherever hosted and whenever possible, PPD should be aligned with existing institutions to maximise the institutional potential and minimise friction.

Structure and participation: PPD’s structure should be manageable while flexible, enable participation to be both balanced and effective, and reflect the local private sector context.

Champions: It is difficult to sustain dialogue without champions from both the public and private sectors, who invest in the process and drive it forward.

Facilitator: A facilitator who commands the respect of stakeholders can greatly improve the prospects of PPD.

Outputs: Outputs can take the shape of structure and process outputs, analytical outputs or recommendations. All should contribute to agreed private sector development outcomes.

Outreach and communications: Enabling communication of a shared vision and understanding through the development of a common language is essential for building trust among stakeholders.

Monitoring and evaluation: This is an effective tool to manage the public private dialogue process and to demonstrate its purpose and performance.

Sub-national: Public-private dialogue is desirable at all levels of decision-making, from the most local possible level, especially as this is likely to be more practically capable of involving micro-entrepreneurs, SMEs and other local stakeholders.

Sector-specific: Sector-specific or issue-specific public–private dialogues should be encouraged because they provide more focus, greater incentive to collaborate, and more opportunity for action.

International role: Broad and inclusive public–private dialogue can effectively represent and promote national and regional interests of both public and private actors in international negotiations and international dialogue processes.

Post-conflict / Crisis recovery / Reconciliation: Public-private dialogue is particularly valuable in post-conflict and crisis environments – including post-natural disaster – to consolidate peace and rebuild the economy through private sector development.

Development partners: Public-private dialogue initiatives can benefit from the input and support of donors (development partners) when their role is determined by the local context, demand-driven, and based on partnership, coordination and additionality.

Source: Herzberg and Wright (2013)

¹⁷ The national competitiveness council in Colombia has been one of the most active and effective instances of national level PPDs (Eslava, Meléndez, and Perry, 2014). Created in 2006 by the government of Álvaro Uribe, the council elicited active participation by business through a special organisation created by business, the CPC (Consejo Privado de Competitividad). The CPC was an innovative organisation with a broad membership by both large firms—national and MNCs—and major associations, and directed by a small executive committee that worked closely with government, and whose decisions and strategies were ratified periodically by the larger organisation (Schneider 2013).

¹⁸ A similar point can be made about other forms of state-business interactions such as Presidential Investor Advisory Councils and Investment Promotion Agencies.

4.6 Investment facilitation

Investment facilitation usually takes place through an **investment promotion agency** (IPA), typically a government agency whose mission is to attract investment to a country, state, region or city. IPAs usually have four roles (OECD 2011):

- **advocacy** within government to seek necessary approvals or urge the removal of obstacles to investment;
- **image building** to promote the country as an investment destination;
- **investor servicing or facilitation** to help solve problems faced by existing or potential investors;
- **targeting or investment generation** by actively seeking out investors based on national development plans or other criteria.

Donors such as the World Bank have focused extensively on helping IPAs in conflict-affected countries to attract foreign investment.

The literature suggests that centralising foreign investment promotion and facilitation activities (such as information dissemination and policy advocacy) through an IPA can be cost effective and can credibly signal the state's intention to the private sector that it is interested in attracting foreign direct investment and improving the business environment (te Velde 2006).

However, the evidence on whether IPAs in low income countries have actually succeeded in attracting foreign investment is limited. Most of the examples of successful IPAs are from developed countries such as Ireland and Singapore.

In a study of 58 countries, Morisset and Andrews-Johnson (2001) find that IPA effectiveness strongly depends on the country's business environment, and is positively correlated with the quality of the investment climate. They also find that low-income countries get increased inflows of foreign direct investment from improving the business environment rather than from investment promotion. Gomez-Mera et al. (2014) find that IPAs play only a marginal role in raising awareness of investment opportunities in developing countries, and are not particularly effective in many African countries. However, once investors have made the decision to enter a specific market, IPAs appear to be a widely used and useful resource for investors, especially for smaller and less productive firms.

Williams (2004) and Higgins (2012) argue that the role played by investment promotion agencies can be gender sensitised and they can help to promote simplified procedures and single window approaches targeted at women. Peschka (2011) notes that, in FCAS contexts, IPAs are reluctant to directly acknowledge political risks or suggest risk mitigation options, limiting their effectiveness.

More evidence is needed in assessing whether well-functioning IPAs do contribute to effective state-business relations in low income countries, and in identifying the political drivers of successful IPAs in those contexts.

5. Implications for future research, policy and programming

5.1 Key issues around state-business relations

The literature suggests that effective state-business relations are a key determinant of economic growth and structural transformation. The evidence is drawn from statistical research and country case-studies, mostly from East Asia. There is limited evidence that effective state-business relations can also contribute to improving the wider governance environment.

The literature highlights five **correlates of effective state-business relations**:

- credible commitment on the part of the government to policies, deals or arrangements;
- formal and informal mechanisms that facilitate consultation, coordination and reciprocity between the state and business;
- sharing of information between the private sector and government;
- a stable policy environment;
- the role of checks and balances on government policy.

Key factors that explain the **emergence and sustenance** of effective state-business relations are:

- state capabilities;
- the structure and capacity of the private sector;
- dominant ideologies and elite incentives.

There is limited evidence of effective state-business relations emerging in the FCAS and low income country contexts. The literature identifies six **political economy barriers** to the emergence of effective state-business relations in such contexts:

- the nature of the political settlement and elite commitment to growth;
- the nature of the private sector;
- the nature, extent and predictability of corruption;
- the prevalence of fragility and conflict;
- the nature of regulation;
- privatisation and the role of state-owned enterprises.

5.2 Approaches to state-business relations: guidance for donors

The literature provides the following considerations for donors:

- **State-business relations matter** – Productive collaboration between the state and the private sector to address market and government failures – whether through formal or informal mechanisms – is ultimately what drives economic transformation. In countries where economic transformation has occurred, a process of consultation and coordination between the state and the private sector has taken place – to inform the design of appropriate policies and interventions, and to generate feedback on what is working and what is not.

- **Economic sectors** – There is a need to move beyond economy-wide approaches to investment climate reforms towards tackling constraints that underpin specific economic sectors, and the political factors that ensure these constraints persist.
- **Unpacking the private sector** – This is a diverse group of businesses that experience different constraints and challenges and have different motives and incentives. The challenge is to identify specific actors within the private sector that offer the greatest chances of delivering transformational change, and to engage with the specific forms of corruption and mismanagement that prevent them from growing, investing or adopting new technologies. An equally important imperative is to ensure the state develops a strong disciplining function, enabling it to withdraw support from underperforming firms or industries.
- **Going beyond the formal ‘investment climate’** – Wholesale reforms that improve the national ‘investment climate’ can be difficult in DFID countries. Furthermore, these reforms can affect firms in different ways. There is huge variation of firms within the same country, which suggests that instead of just looking at the overall national investment ‘climate’, we should also look at how micro-climates for different kinds of firm are created and to what extent they can enable ‘deals’ to happen.
- **Rules and deals** – Efforts to improve laws and regulations may not actually improve the formal prospects for business and investment to flourish (Hallward-Driemeier and Pritchett 2015). Depending on the political economy environment, they may have little impact on the *de facto* investment climate that firms actually experience. In these contexts, there may be initiatives that have little impact on the formal rules/investment climate, but which have a significant impact on the ‘deals’ environment and on investor expectations in ways that can help accelerate growth. The challenge will be to identify opportunities for the latter (Pritchett and Werker 2013).
- **Supply and demand** – Improving the prospects for credible deals to take place will involve working with supply-side and demand-side actors and institutions. It will be especially important to find ways to tackle specific issues from both angles simultaneously, or to identify issues of interest to both sides.
- **Strengthening capacity** – Strengthening the capability of the economic bureaucracy, improving organisational capacity, and increasing the representativeness of business associations to include small firms are likely to increase the effectiveness of state-business relations. This is especially the case where state capacity is limited, the private sector is fragmented, and business associations are subject to capture by large firms. The challenge here is to strengthen the capacity of the government to respond to the changing needs of, and challenges faced by, the private sector in an iterative but swift way. This will involve strengthening coordination among government agencies.
- **Improving links across disciplines** – For donors, encouraging more productive state business-relations requires a politically-informed approach. It means understanding the context-specific relationships between governments/the state and the private sector – i.e. the interests, incentives and dynamics among different kinds of political and economic actors and political elites. This needs to be combined with a wider appreciation of the feedback loops between growth and state capability. To do this effectively, much closer collaboration is needed between governance, economic and private sector specialists.

5.3 Key gaps in the evidence base

There is a lack of systematic analysis of the characteristics of effective state-business relations in low income and FCAS country contexts. The literature is predominantly conceptual, and the empirical evidence is mostly qualitative and largely consisting of country case studies. Most case studies are from East Asia, with relatively few studies of African and South Asian countries. There is also a lack of recent empirical evidence on the political drivers of how effective state-business relations emerged and were sustained, especially in low income contexts, with most of the empirical evidence drawn from case studies undertaken before 2000.

While there is statistical and case-study evidence on the positive impact of effective state-business relations on economic development, the evidence on how state-business relations may contribute to the wider governance environment is limited.

There is also limited evidence on the success of donor interventions in contributing to effective state-business relations in low income and FCAS contexts. A lack of baseline data limits the usefulness of *ex post* impact evaluations of donor interventions, and there has been a lack of rigorous experimental methods such as randomised control trials.

5.4 Key research questions and priorities

The review of the literature suggests the following key research questions and priorities:

Research questions

1. What are the characteristics of effective state-business relations in low income countries? How do they emerge and how are they sustained? What are their developmental impacts, especially on the wider governance environment?
2. Under what conditions are informal 'hand-in-hand' relationships between the state and business effective? What factors prevent them from being collusive?
3. How can donors better design interventions that improve state-business relations in FACS and low income countries? Which approaches work best and why?
4. Which parts of the private sector are most likely to demand more effective state-business relations? How can donors best support private sector actors and business associations that are likely to push for more collaborative and transparent relations with the state?

Priorities

1. Case studies of state-business relations, and how they become effective in FCAS and low income countries
2. Impact evaluations of donor interventions in improving state-business relations
3. Perception based surveys of what the public and private sectors see as the key constraints to the emergence of effective state-business relations
4. Systematic analysis of the different approaches to improving state-business relations, with case-studies of successes and failures
5. Quantitative studies on the impact of state-business relations on economic development and the governance environment, with improved measures of effective state-business relations.

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