

# STATE BUSINESS RELATIONS AND ECONOMIC PERFORMANCE

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# What do we understand by effective State Business Relations (SBRs)?

- “a set of highly institutionalised, responsive and public interactions between the state and the business elite”

# What characterises effective SBRs?

- *Transparency* in information
- *Reciprocity* in actions
- *Credibility* in statements
- *Trust*
- *Absence of collusive behaviour* between business and states

# Effective vs Ineffective SBRs

Effective SBRs are more likely to be characterised by collaborative and synergistic relations between the state and the business elite

Ineffective SBRs will be more likely to be characterised by collusive and rent-seeking relations between the state and the business elite

# Two over-arching questions

- Why and how do SBRs matter for economic development?
- When, where and why do effective SBRs emerge? What explains their evolution over time?

# NOTHING NEW ABOUT SBRs

- Smith
- Marx
- Schumpeter
- Bates and Evans
- Industrial Policy
- Charles Lindblom's classic on *Politics and Markets*
  - 'Core of political science and economics'
  - Application to developing countries recent

# Through the lens of SBRs, we can re-assess some big debates in development policy and thinking

- States versus Markets
- Market Failure and Government Failure
- Which institutions matter? How do they matter?

# States versus Markets

- An early view on the determinants of economic growth argued that economic growth occurs in contexts where the state respects the property rights of private producers and where it does not expropriate property or allows others to do so.
- However, as has been witnessed in East Asia, economic growth has occurred in contexts where there were strong collaborative relations between the political and economic elites.
- ‘good growth-enhancing relations between business and government elites are possible’ (Maxfield and Schneider 1997)



# A developmentally positive relationship between the state and the market

Two pre-conditions for economic growth:

- i. The creation of a positive environment for private investment, in which capitalists have confidence that their activities will be supported and not frustrated by the state
- ii. The state has the capability (and willingness) of restraining the negative effects of collusion between individual business people and agents of the state.

*Creating the institutional conditions for the maintenance of benign collaboration between agents of the state and business.*

# Two Views of the State and the Private Sector

- The Predatory State vs the Developmental State
- Rent-seeking Business Associations vs Developmental Business Associations
- Arms length versus collaborative/'hand in hand'

# Market Failures and Government Failures

- ***Effective SBRs can help prevent both government failures and market failures.***
- **HOW DO THEY PREVENT MARKET FAILURE?**
- They help solve information related market and co-ordination failures (e.g, business associations monitoring their members and ensuring compliance).
- They solve *collective action* problems.
- 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.

# SBRs and Government Failure

- Effective SBRs lead to **credible commitment** on the part of the government to certain policies can minimise uncertainties on future policy actions in the minds of investors.
- Creates an institutional environment where the state provides **high quality public goods** that matter to the private sector such as infrastructure, effective public administration and secure property rights.
- **Check and balance function** on government tax and expenditures, and policies.

# Which (Economic) Institutions Matter?

- The Northian view of 'good' institutions was focused on well defined and secure *private* property rights. Influenced WDR 2002 and the De Soto agenda. Shaped most of the empirical work that followed (AJR, Rodrik et. al., Hall and Jones...)
- The Williamsonian emphasis was on transactions costs – WB interpreted this narrowly in their Doing Business surveys to mean any regulatory/legal and extra-legal impediments to the investment activities of firms.
- More recent theoretical literature allows a broader view of institutions - as coordination/governance mechanisms - and recognise that informal institutions may dominate formal institutions as a means of governance in certain contexts (Dixit, AEA Presidential Address 2009).

# SBRs as coordination mechanisms

‘The rules of the game and the players of the game’

- SBRs embody both formal and informal institutions- both rule and relationship based governance.
- The players: organisations – business associations, trade unions, ministries, public sector agencies.
- Subsumes property rights and transactions costs, but allows a more nuanced and wider lens through which to look at institutional questions.



# Why and how do SBRs matter for economic growth?

- To understand their effects on growth, we need to measure the effectiveness of SBRs.
- We need a measure that is time-varying and across countries/regions within countries to capture the effects of SBRs both over time and across space (panel data).
- We need a measure which is based on the **observable** features of effective SBRs, mostly relying on secondary data.

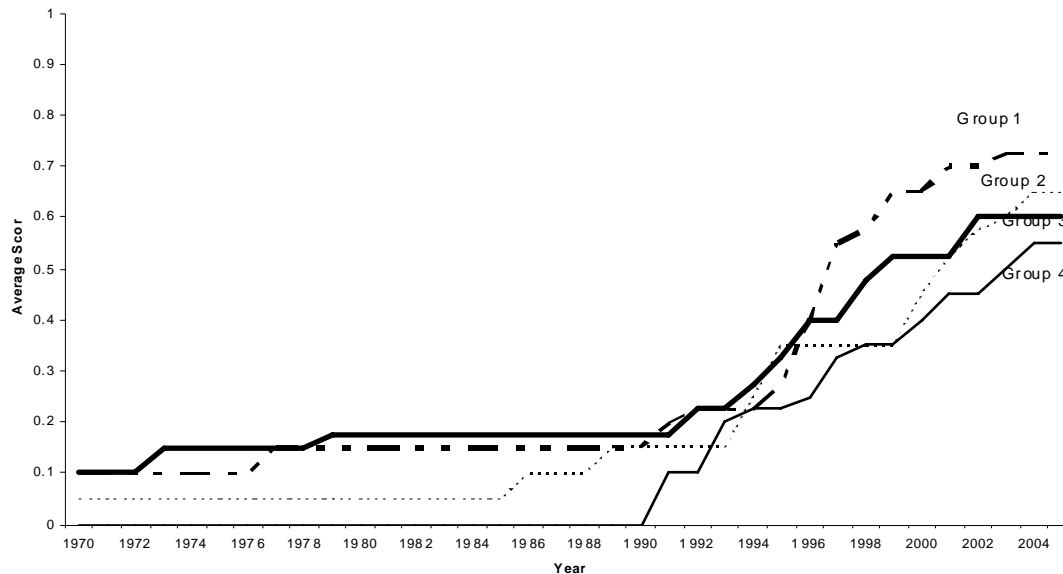
# Measuring SBRs

- How is the private sector is organised vis-à-vis the public sector?
- How is the government is organised vis-à-vis the private sector?
- How are SBRs practiced and institutionalised?
- What mechanisms are there for the avoidance of harmful collusive behaviour?



# SBRs in Africa

Chart 1 Higher SBR scores for groups of faster growing countries



**Notes:** Group 1 = Botswana, Mauritius, Uganda, Mozambique, Mali; Group 2 = Tanzania, Ghana, Eritrea (part), Senegal, Kenya; Group 3 = Benin, Ethiopia, South Africa, Nigeria, Rwanda; Group 4 = Malawi, Zimbabwe, Madagascar, Zambia, Cote d'Ivoire. Groups based on PPP GDP per capita growth rates over 1980–2004.

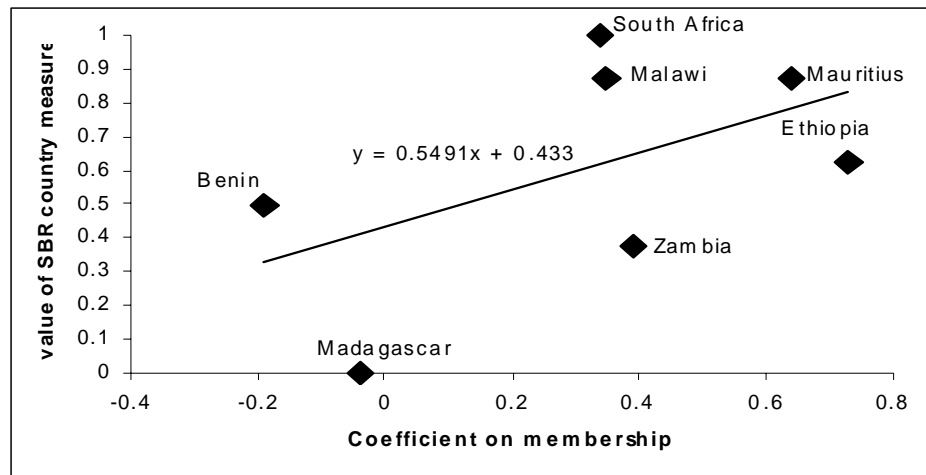
# The macro-effects of SBRs

- Dynamic panel data regressions of the determinants of economic growth in Africa show that effective SBRs have strong positive effect on economic growth in SSA (significant at 1 per cent level in most regressions).
- This effect remains robust to the inclusion of other measures of institutional quality, and other controls (open-ness, govt consumption, inflation).
- *See Sen and Te Velde, JDS 2009.*

# The micro-effects of SBRs

- How do SBRs affect firm performance?

**Chart 4** The effect of business association membership on productivity is greater in countries which are better prepared for state-business relations



# Explaining regional growth in Indian States

- While economic growth in India has been strong since the mid 1980s, not all regions in India have benefited equally from the improvement in overall economic performance.
- India's federal structure and the significant political autonomy and independence in legislative powers enjoyed by state governments, along with regional variations in the collective strength of the economic and political elite, has led to strong variations in SBRs across states in India.

# Measuring SBR In Indian States

- 1. How is the private sector organised?
- 2. How is the public sector organised?
- 3. Practice of SBRs
- 4. Presence of Collusive SBRs

Each given equal weight; coded from 0 to 1; and aggregated to form an overall measure of SBR (which varies from 0 to 1)

# How is the private sector organised?

- Is there an **umbrella business association** and when did it come into being?
- Whether the private sector association has a **website** or not, and since when?
- How **frequently** the website is updated
- Is the **office** of the assoc owned or not?
- We look at the main private sector assoc for the state, and the two leading industry assocs.

# How is the public sector organised?

- The presence of state owned or state participated productive corporations, which are investment promotion agencies, financial, infrastructure development and tourism development corporations.
- The governments' signalling of their relative priorities through the **allocation of public resources to productive sectors** – share of economic services in total govt expenditures.

# How is SBR practised?

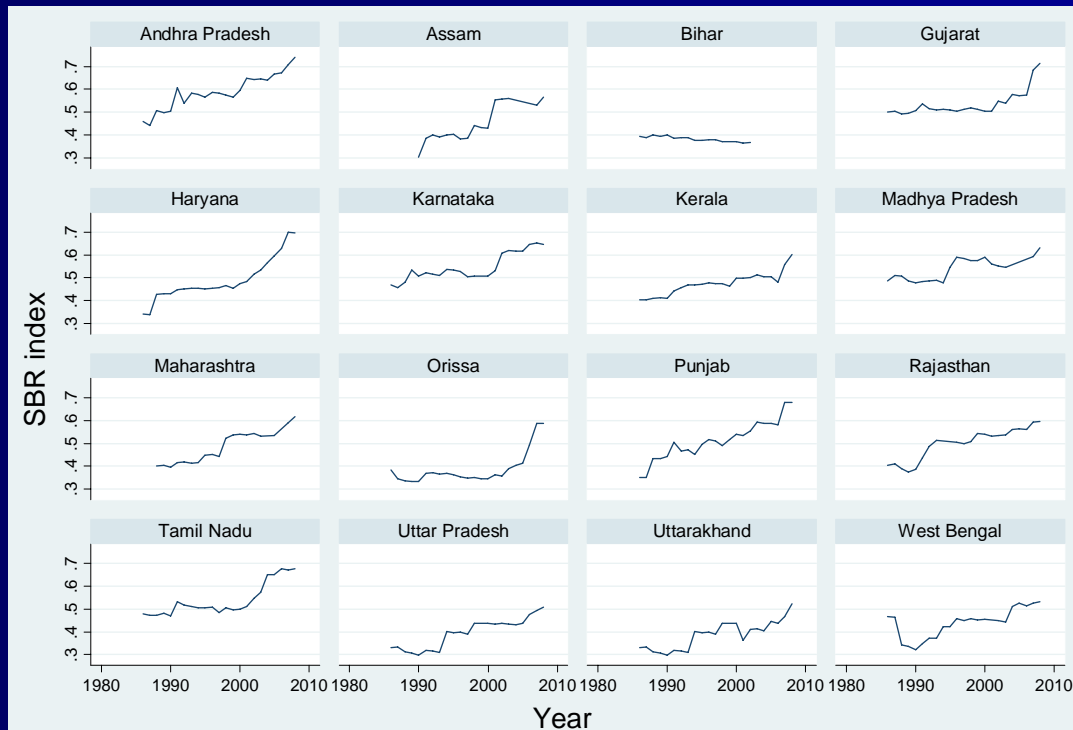
- **Labour regulation** – Labour laws in India are mostly state-specific, and different states have enacted changes in labour laws, which are either pro-workers/anti-business or pro-employer (Tim Besley and Robin Burgess have coded these changes in laws).
- **Stamp duty** as a measure of the attitude of the state governments towards business establishments and their expansion.



# What are the mechanisms to avoid collusive behaviour?

- The gross output of firms belonging to **delicensed industries** as a proportion of total industrial GDP
- Whether the private sector umbrella association has a **regular publication** informing its members (and from when).
- The **frequency** with which the publication is produced and distributed.

**Figure 1: Evolution of the Effectiveness of State Business Relation measure in Indian States, 1985-2006**



# Estimating the Effects of SBRs on State-level Growth in India

- Dynamic panel data regressions, with 15 states and period: 1985-2004
- Year effects: year-specific national level shocks, e.g. weather shocks and other macroeconomic shocks
- State specific effects: innate cultural and geographical properties of states that are time-invariant.

# Other Controls

- Demographic factors such as rural and urban population and the female-male ratio; literacy rate and per capita expenditures on education and health, real cost of power supply and state-specific average rainfall per year
- In some specifications we include state-specific time trends in addition to year and state effects to capture state-specific long term trends of SBRs and growth.

# Reverse Causality issues

- We use two sets of instruments:
  - Land reform implemented under 1949 Indian Constitution. Each state parliament implemented the reform through autonomous acts.
  - Differences in implementation captured by Besley and Burgess (2000)
- States which implemented land reform aggressively were likely to be concerned mainly with the rural sector and the rural poor, rather than industrialists.
- We would expect the intensity of the land reform legislation to be inversely related to the quality of SBRs.
- But land reform did not have any significant effect on the rate of growth.

# Electoral Outcomes as instruments for SBR

- We exploit the fact that SBRs are the outcome of a political process, with different groupings in state legislatures (the *Vidhan Sabha*) having different propensity to engage with businesses.
- We use data from records of the number of seats won by different national parties at each of the state elections under four broad groupings in line with the classification by Besley and Burgess (2000). The parties are (i) Congress Party, (ii) a *hard left* grouping (iii) a *soft left* grouping.

# First Stage Findings

- In line with our priors, land reform legislation (lagged two years) appears to be negatively and significantly associated with the SBR variable.
- The electoral results variables are also broadly in line with the expectations although they are not significant.
- Congress parties are associated with increasing SBRs, while hard left parties are associated with decreasing SBRs.
- On the other hand, soft left and Hindu parties decrease the SBR measure.
- The lack of significance of the electoral variables suggests that SBRs are not driven mainly by the electoral results.

# Second stage Findings

- The SBR variable is positive and significant at the 1 per cent level, when we add full set of controls.
- A one per cent increase in the SBR measure leads to a three per cent increase in long-run growth.



# Disaggregated Second stage Findings

- We investigate which dimensions are driving the positive impact of SBR on growth.
- *SBR private* is the only dimension not significantly different from zero.
- The others have the expected positive sign except the public sector variable, which is negative and significant.
- Interestingly, among the four components of the SBR measure, the component that is highly significant at the 1 per cent level is *SBR practice*.

# Counter-factuals

- Other things being equal, if Bihar (one of the worst performing states in India) had the same average (fitted) value of the SBR index over 1985-2006 as Gujarat, its annual rate of growth would have been 2.5 percentage point higher over the same period.
- This is a substantial increase over Bihar's actual average rate of growth of 1.4%. Similarly its growth rate would have increased by 12% relative to its growth trend over the same period.

# Functioning matters, not the form

- The results suggest that the key dimensions of SBRs that stimulate economic growth seem to be those related to the actual operations of the interactions between states and businesses.
- Confirms the arguments made by Atul Kohli, Rodrik and Subramanian and Bradford De Long on the role of the 'attitudinal shift' of the state in explaining India's growth acceleration at the national level. Our findings suggest a similar story at the sub-national level.
- On the other hand the formal organisations (both public and private) in place to favour such interactions seem to be even counterproductive for economic growth.

# What explains the emergence of effective SBRs in some contexts and not in others?

- Development ideologies and goals of dominant political and economic *elites*
- Relative power of state vis a vis that of business elite/s
- Organisation of the bureaucracy and bureaucratic organisations
- Form, structure, multiplicity and representativity of Business Associations (BAs).
- Formal and informal institutional arrangements linking S and B
- Leadership / human agency.

# Malawi vs Mauritius -1

Malawi: Collusive and Predatory SBRs, shaped by 3 factors:

- i) low level of capitalist development in the country;
- ii) the dominant influence of the Malawian state under Banda in the first 30 years of independence;
- iii) the lack of distinction between the public and the private, due to informal institutions of generalised reciprocity.

(Chingaipe-Leftwich IPPG DP 7).

# Malawi vs Mauritius - 2

## Mauritius: Collaborative and synergistic SBRs

- Recognition of shared goals between political and economic elites
- Joint Economic Council (JEC) since the 1970s
  - Regular meetings, consultation, joint delegations

# West Bengal vs Andhra Pradesh -1

- West Bengal: ruled by a Left government since 1977
- Antagonistic attitude of the state government towards central govt and business in the 1980s;
- Signals change in attitude towards business in 1994 (New Industrial Policy).
- Chakravarty and Bose find that very little change in manuf outcomes – increasing contraction of formal manufacturing sector.
- They trace it to a fractured dominant coalition ambivalent about reforms; an industrial work-force still shaped by attitudes of the past towards work and wage bargaining; and a party machinery embedded in the promotion of clientelism.

# West Bengal vs Andhra Pradesh -2

- AP: Initial hostility towards business and to manufacturing in the 1950s and early 1960s.
- Change in SBR in the mid 1960s with the emergence of a prosperous rural capitalist class looking for investment opportunities in manufacturing.
- Leadership played a part: Naidu and the IT boom.
- Credible commitment: Relative similarities towards business among both main political parties in the state.

*See Alivelu, Srinivasulu and Reddy.*



# Policy Implications

- Support and broker *processes* which facilitate good SBRs
- May not be of the Washington Consensus 'arms length' variety.
- Donors need to see business associations as agents for development.
- States need to facilitate the emergence of strong and representative business associations.
- Support for SBRs should be provided by strengthening the actual practice of SBRs rather than by establishing formal organisations to carry out such interactions.