Effective state-business relations, industrial policy and wealth creation

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When the state and business interact effectively, they can promote more efficient allocation of scarce resources, conduct a more appropriate industrial policy, remove the biggest obstacles to growth and create wealth more efficiently. When the two sides fail to cooperate, or engage in harmful collusion, economic activity centres on wealth creation for the few rather than the many. This note explains why effective interactions between state and business matter for wealth creation. Other briefings consider how such interactions can be measured. A key theoretical issue is how to conceptualise and formalise the way in which different types of state-business relations (SBRs) constrain the conduct of industrial policy to create wealth.

There used to be a long-established view that SBRs in development are collusive and rent extracting (e.g. Doner and Schneider, 2000, on changes in the perceived role of business associations in growth). Further, mainstream economists had long held the position that a reduced role for the state and market liberalisation by itself would lead the price mechanism to allocate resources efficiently, leaving no room for an active complementary industrial policy. Such mainstream economists acknowledged the presence of market failures in theory, but in practice these were not thought to be sufficiently wide ranging to justify a strong intervening role for the state (e.g. the World Bank's World Development Report (2005) on the investment climate does not mention industrial policy). The global financial crisis and the need to address climate change, but also other developments, have affected the belief that the market, or government, can do everything on its own. A more nuanced view of the respective roles of state and business, and their interaction, is now being considered.

The political science and governance literatures have begun to identify what can be considered as characteristics of effective SBRs. For example, political scientists suggest that good SBRs are based on benign collaboration between business and the state (Harriss, 2006), with positive mechanisms that enable transparency, ensure the likelihood of reciprocity, increase state credibility among the capitalists and establish high levels of trust between public and private agents. They provide a transparent way of sharing information, lead to more appropriate allocation of resources, remove unnecessary obstacles to doing business (i.e. a good investment climate) and provide checks and balances on government intervention.

Doner and Schneider (2000) discuss a number of market-complementing functions of business associations as key agents in the conduct of organised SBRs: macroeconomic stabilisation, horizontal and vertical coordination, lowering costs of information, standard setting and quality upgrading. Lin and Monga (2010) have reinvigorated the debate on the role of the state in promoting market-oriented growth, arguing that growth-enhancing policies work best when they follow the comparative advantage of the country.

The role of agencies and their effective interactions constitute a useful complement to the price mechanism in allocating resources and promoting efficient wealth creation. The rationale for SBRs rests on the following building blocks. There are market failures (the market alone cannot achieve an optimal allocation of resources) and there are government failures (state actors may not be able to address market failures on their own). Effective SBRs can address such market and coordination failures and government failures, and can reduce policy uncertainty (we discuss this below).

Effective SBRs address market and coordination failures, which constrain growth of small and large firms

Effective SBRs can help solve information-related market and coordination failures in areas such as skills development (Lall, 2001), infrastructure provision, technological development (ibid) and capital markets (Stiglitz, 1996). Business associations and government departments may help to coordinate dispersed information among stakeholders. The coordinating actions of these agents allow a country to create wealth at a faster rate. A good example is where business associations lobby the government, e.g. to provide more appropriate and good quality education and infrastructure, which is unlikely to be supplied through a fragmented private sector which relies on a price mechanism based on incomplete markets. Our econometric work based on

a large survey of firms in a number of sub-Saharan African countries (Qureshi and Te Velde, 2007) suggests that both small and medium-sized enterprises (SMEs) and large firms derive growth benefits from being a member of a business association, consistent with their stated preferences that business associations lobby on their behalf (in addition to direct lobbying) and provide relevant information. Whereas SMEs and large firms make a similar contribution to growth, the growth constraints are different (Kurokowa et al., 2008), and business associations can help SMEs lobby for the removal of SME growth constraints.

Effective SBRs address failures in government policy designed to overcome market failures

Public support may fail to correct market failures, for several reasons. Governments are unlikely to have perfect information and perfect foresight; government intervention can suffer from moral hazard problems (Hausman and Rodrik, 2002), in that the private sector may not act once the government has provided an incentive; private non-market means can solve market failures; joint action may raise collective efficiency, by internalising externalities, and this could be more appropriate than state intervention; national-level coordination failures based on scale economies are probably the most far reaching in scope and hence the most risky; and government intervention carries the risk of misallocation and rent-seeking behaviour.

Effective SBRs (e.g. a democratic way of conducting SBRs underpinned by the principles enshrined in an effective competition policy) provide a check and balance function on government policies and their tax and expenditure plans (Bwalya et al., 2009 suggest how the private sector in Zambia can be successful in its budget proposals). Effective SBRs may help to ensure that the provision of infrastructure is of good quality and appropriate to the needs of the market (and avoid circumstances where technology institutes are supply driven and delinked from the private sector, see Lall, 2001 in the case of Tanzania). The design of effective government policies and regulations depends, among other things, on inputs from and consultation with the private sector. Regular sharing of information between the state and businesses ensures that private sector objectives are met with public actions and that local-level issues are fed into higher-level policy processes. The private sector can identify constraints, opportunities and possible policy options for creating incentives, lowering investment risks and reducing the cost of doing business. This can facilitate appropriate and active market-friendly interventions. More efficient institutions, rules and regulations might be achieved through policy advocacy, which could reduce the costs and risks faced by firms and enhance productivity.

SBRs can help to address coordination failures, as government action on its own is risky. Any intervention needs to be updated when new information becomes available, and it is therefore essential to consult the market through effective SBRs. Stiglitz argues that flexibility of policy interventions is important in securing a positive outcome.

Effective SBRs can reduce policy uncertainty; promote innovation and create wealth

Effective SBRs and membership of business associations may help to reduce policy uncertainty. Firms operate in an uncertain environment and frequently face risks and resource shortages. They undertake decisions concerning technology, inputs and production facilities based on anticipated market conditions and profitability. Uncertainty can have significant negative effects on investment and hence wealth creation, when investment involves large sunk and irreversible costs and there is the option to delay the decision to make the investment until further information becomes available (Dixit and Pindyck, 1994). Policy uncertainty is an important source of uncertainty. Businesses that have a better relation with the government may be able to anticipate policy decisions. When this relation becomes too close, collusive behaviour may result in capture of policy to the benefit of few, not all, firms. A key problem is to understand when SBRs are of the collusive type and when they are developmental. Econometric evidence from Mauritius (Rojid et al., 2009) suggests that improvements in SBRs over the past three decades have led to more appropriate growth-enhancing policies and more fixed capital formation crucial for wealth creation. Evidence from around 1,000 firms in a number of sub-Saharan African countries finds that firms that are a member of a business association pay a lower percentage of revenue as informal payments to government officials, face lower lost costs of insufficient water supply and make more use of information and communication technology facilities. This suggests that organised SBRs play an important role in the creation of good institutions and governance, and the establishment of a better investment climate (Qureshi and Te Velde, 2007).

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