Research Programme Consortium for Improving Institutions for Pro-Poor Growth

IPPG Briefing Note
November 2009

Do effective State-Business Relations Matter for Economic Growth? Evidence from India States.

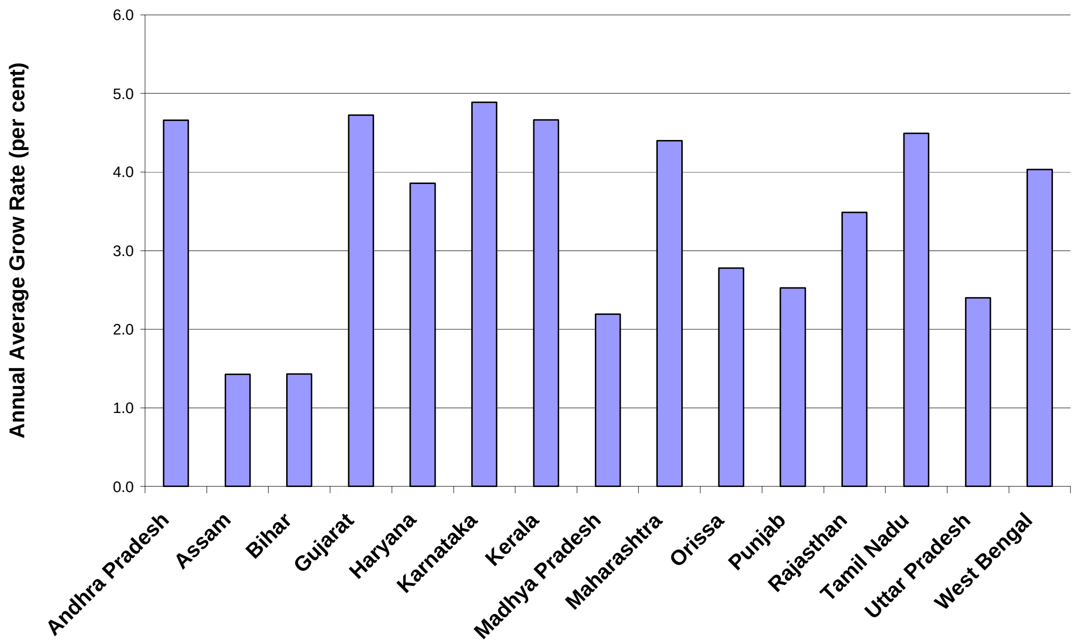
Effective state-business relations (SBRs) are a set of highly institutionalised, responsive and public interactions between the state and the business sector. What are the growth implications of effective state-business relationships – 'the maintenance of benign collaboration between the agents of the state and business' (Harriss 2006.)? Surprisingly, we don't know very much about the growth effects of effective SBRs. So far, the literature on institutions and economic growth has focused its attention primarily on the predatory role of the state. The main finding of the empirical studies in this literature is that economic growth has occurred in contexts where the state has respected the property rights of private producers and where it did not expropriate property or allow others to do so. However, as it has been witnessed in East Asia, economic growth has occurred in contexts where there were strong collaborative relations between the political and economic elites. In contrast to the state's predatory role highlighted in the recent empirical literature on institutions and growth, there has been little recognition in this literature of the state's developmental role and that 'good growth-enhancing relations between business and government elites are possible' (Maxfield and Schneider 1997).

The effectiveness of the relationship between the state and the business sector is, thus, an over-looked aspect of institutional quality in the empirics of economic growth and could play a decisive role in economic growth, independent of other factors that have been found to be important in explaining economic growth. India provides an appropriate empirical context to understand the role of effective state business relations on economic growth for a number of reasons. First, the federal structure of the country implies a significant political autonomy and independence in legislative powers enjoyed by state governments, providing an important source of variation in the public economic institutions across states. Such variation also occurs over time due to regime changes at the state level along with the attitudinal changes of state governments to the business sector, partly brought about by economic reforms. Second, Indian states are characterised by marked regional variations in the collective strength of the economic and political elites. These factors lead to potentially significant variation in SBRs across Indian states and over time.

Economic growth across Indian states

While economic growth in India has been strong since the mid 1980s, not all regions in India have equally benefited from the improvement in overall economic performance. States like Andhra Pradesh, Gujarat, Karnataka, Kerala and Tamil Nadu have grown at an average rate of per capita income which has exceeded 4.5 per cent per annum during the 1985-2006 period. On the other hand, states such as Assam, Bihar and Madhya Pradesh have grown at around 2 per cent or less in the same period (see Figure 1). In contrast to the experience of China, where geographical factors such as land-lockedness and access to the sea explain to a large extent the patterns of regional economic performance, there is no clear correlation between geography and regional growth in India. Land-locked states such as Punjab and Haryana have exhibited strong economic growth while coastal states such as Orissa have experienced significantly weaker economic performance.

Figure 1. Variations in Economic Growth across States in India, 1985-2006



Measuring SBRs in Indian states

To quantify the effects of state business relations on economic growth, it is necessary to measure the effectiveness of state business relations. Cali, Mitra and Purohit (2009) propose a measure that can capture the four dimensions of effective state-business relationships – i) the way in which the private sector is organised vis-à-vis the public sector; ii) the way in which the public sector is organised vis-à-vis the private sector; iii) the practice and institutionalisation of state-business relations; and iv) the avoidance of harmful collusive behaviour. They aggregate a number of variables gathered from both primary and secondary sources to measure each of these dimensions. In this way they compute both state-wise sub-indices for each SBRs dimension and an aggregate state-wise SBRs index (as an average of all sub-indices). The latter measure shows an unambiguous improvement in SBRs across most Indian states over 1985-2006. However, the rate of improvement has differed widely across states, and has occurred at different points in time in different states. This suggests that state-specific political and economic factors may have conditioned the nature of SBRs in any given state, and that these factors have differed across states and over time. In addition, there are some states where SBRs have remained stagnant since the mid 1980s, indicating the path-stickiness of the institutions governing SBRs in these states.

The effects of effective SBRs on growth

Using the SBR measure, standard growth regressions for fifteen Indian states are estimated in dynamic panel form. The empirical analysis controls for demographic factors, human capital, infrastructure, climactic factors, and state and year fixed effects. These effects take into account innate geographical and cultural differences across states and the time-varying shocks common to all states, such as macroeconomic shocks to output. The analysis also addresses the possibility of reverse causality from income growth to improvements in SBRs by using an instrumental variable method, and a set of instruments which are drawn from India's political history, including land reform legislation and electoral outcomes at the state level. The analysis shows that effective SBRs contribute significantly to economic growth across states in India. Thus, SBRs that lead to an active co-operation between the state and the business sector will foster investment and increases in productivity, and consequently, increase economic growth. 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. On the other hand the development of new formal organisations (both public and private) to favour such interactions seems to be even counterproductive for economic growth.

An important policy implication of the research is that the national state and peak business associations should support and broker more collaborative relations between sub-national states and the private sector where such synergistic SBRs have not emerged to the same degree. The focus of this support for SBRs should be on strengthening the actual practice of SBRs rather than on establishing formal organisations to carry out such interactions.

Reference

Calì, M., S. Mitra and P. Purohit (2009), "State Business Relations in Indian States", *IPPG Discussion Paper No. 25,* available at www.ippg.org.uk.

Harriss, J. (2006) 'Institutions and State-Business Relations', London: Improving Institutions for Pro-Poor Growth (IPPG) Briefing Note 2, available at www.ippg.org.uk/research.

Maxfield, S. and B.R. Schneider (1997), eds., *Business and the State in Developing Countries*, Cornell University Press, Ithaca.

Max Cali, Overseas Development Institute, London
Kunal Sen, University of Manchester, UK

IPPG: The IPPG Programme is the shorthand name for the inter-disciplinary Research Programme Consortium on Improving Institutions for Pro-Poor Growth. The DFID-funded IPPG supports innovative scholarly research, and seeks to influence development policy and practice that contributes to the UN Millennium Development Goals (MDGs). IPPG Programme partners are based in South Asia, Sub-Saharan Africa and Latin America. IPPG funds research projects across all these regions.

If you would like to know more about the Research Programme Consortium for Improving Institutions for Pro-Poor Growth (IPPG), please contact the programme office: email ippg@manchester.ac.uk; telephone +44 (0)161 306 6438. Alternatively, please see the IPPG website at **www.ippg.org.uk**