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Analysing the Economics of State-Business Relations

A Summary Guide

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Introduction

It is often suggested that the way in which state and business are organised and interact drive economic performance, but a major research question is how this can be substantiated (this is a companion piece to Adrian Leftwich's analysing the politics of state-business relations). The political science and governance literatures suggest what can be considered as good characteristics of SBRs (Box 1) – in contrast to the long established view that state-business relations in poor countries are collusive and rent-extracting (see e.g. Doner and Schneider on the role of business associations in growth). A major challenge for economic research on SBRs is to understand the relationship between state-business relations and economic performance. This note suggests how this might be done, but does not aim to be prescriptive.

Box 1 The link with the political science literature: the characteristics of effective state-business relations

Good SBRs are based on a benign collaboration between business and the state with positive mechanisms that enable *transparency*, ensure the likelihood of *reciprocity*; increase *credibility* of the state among the capitalists, and establish high levels of *trust* between public and private agents. They provide a transparent way of sharing information, lead to a more appropriate allocation of resources, remove unnecessary obstacles to doing business, and provide checks and balances on government intervention.

The discussion on effective SBRs is linked to the literature on good governance, characterised by four aspects: (1) the rule of law, (2) predictability, (3) transparency, and (4) accountability. This governance structure assumes that the government needs to be fully accountable and needs to provide a sound institutional environment in which a rational private sector maximises profits. Khan points to the importance of feasible reforms.

Sources: Maxfield and Schneider., Harriss, Hyden et al, Grindle, Leftwich

The structure of this note is as follows. Section 2 discusses economic theory and how state-business relations can affect growth. Empirical research then needs to estimate the effects, which depends on measurement of SBRs (Section 3) and an estimation and identification strategy (Section 4). Section 5 discusses the role of the global financial crisis and Section 6 concludes.

Economic Functions of SBRs

Effective state-business relations or public-private sector dialogue are important determinants of economic growth at the macro-level. The rationale for SBRs rests on the following building blocks:

- There are market failures (the market alone cannot achieve an optimal allocation);
- There are government failures (the state may not be able to address market failures on their own);
- Effective SBRs address market and government failures.

State-business relations affect growth through a number of routes, the main three functions of SBRs are:

- Addressing market and co-ordination failures;
- Addressing government failures; and
- Reducing policy uncertainty.

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Addressing market and co-ordination failures

SBRs can help to solve information related market and co-ordination failures in areas such as

- skill development (Lall, 2001),
- infrastructure provision,
- technological development (Lall and Teubal, 2000), and
- capital markets (Stiglitz and Uy, 1996).

Business associations and government departments may help to co-ordinate dispersed information amongst stakeholders.

Addressing government 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 co-ordination failures based on scale economies is probably the most far reaching in scope and hence the most risky.
- Government intervention carries the risk of misallocation and rent-seeking behaviour.

SBRs provide a check and balance function on government policies, tax and expenditure plans. Good SBRs may help to ensure that the provision of infrastructure is appropriate and of good quality. The design of effective government policies and regulations depends, among other things, on input 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. 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 co-ordination 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 using effective SBRs. Stiglitz argues that flexibility of policy interventions is important in securing a positive outcome.

Reducing policy uncertainty

Effective state-business relations and membership of business associations may help to reduce policy uncertainty. Firms operate in an uncertain environment and frequently face risk 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, 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). 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.

Measurement and Forms of SBRs

In order to measure SBRs and assess their importance for economic performance, one needs to determine the key factors behind SBRs.

The literature on measurement of state-business relations (institutional side) is weakly developed (and some maintain measuring a relationship cannot be done):

- Hyden et al. (2004) focuses on 6 governance categories of which economic society is one; this includes (deliberately) subjective questions covering perceptions of state–business relations.
- The Kaufman et al indicators are used extensively by the World Bank, but are about perceptions of governance variables such as government effectiveness and rule of law.
- Investment climate measures in the World Bank's Doing Business Reports are objective (e.g. number of procedures to obtain a licence) but these are unlikely to be fundamental drivers of economic performance (in fact there is little theory surrounding regulation and development), and can be rather seen as outcomes of effective state–business relations, though some factors relate to the current note.

Hence, new measures need to be created to reflect the characteristics of good SBRs (Box 1). In order to obtain credibility and reciprocity we suggest that both the public and private sectors need to be organised or institutionalised. Positive mechanisms for transparency require that some rules or institutions bring the state and business together. We suggest there are four factors to make for effective state-business relations (but the studies can clearly expand and improve on this in the specific research contexts):

1. the way in which the private sector is organised vis-à-vis the public sector
2. the way in which the public sector is organised vis-à-vis the private sector
3. the practice and institutionalisation of SBRs
4. the avoidance of harmful collusive behaviour.

There are visible aspects of state-business relations which could be measured. Some would argue that less visible-informal aspects are equally if not more important. Trust, for instance, is not always dependent on contracts or visible enforcement mechanisms. This we acknowledge. However, we argue that the above visible aspects are important, and that while the informal aspects may influence the links between measurable apects of SBRs and performance they do not do this in such a systematic way that there is no link between formal SBRs and growth. Hence, this note focuses on understanding the effects of the measurable and formal aspects of SBRs.

Measuring SBRs involves the measurement of the four factors identified above:

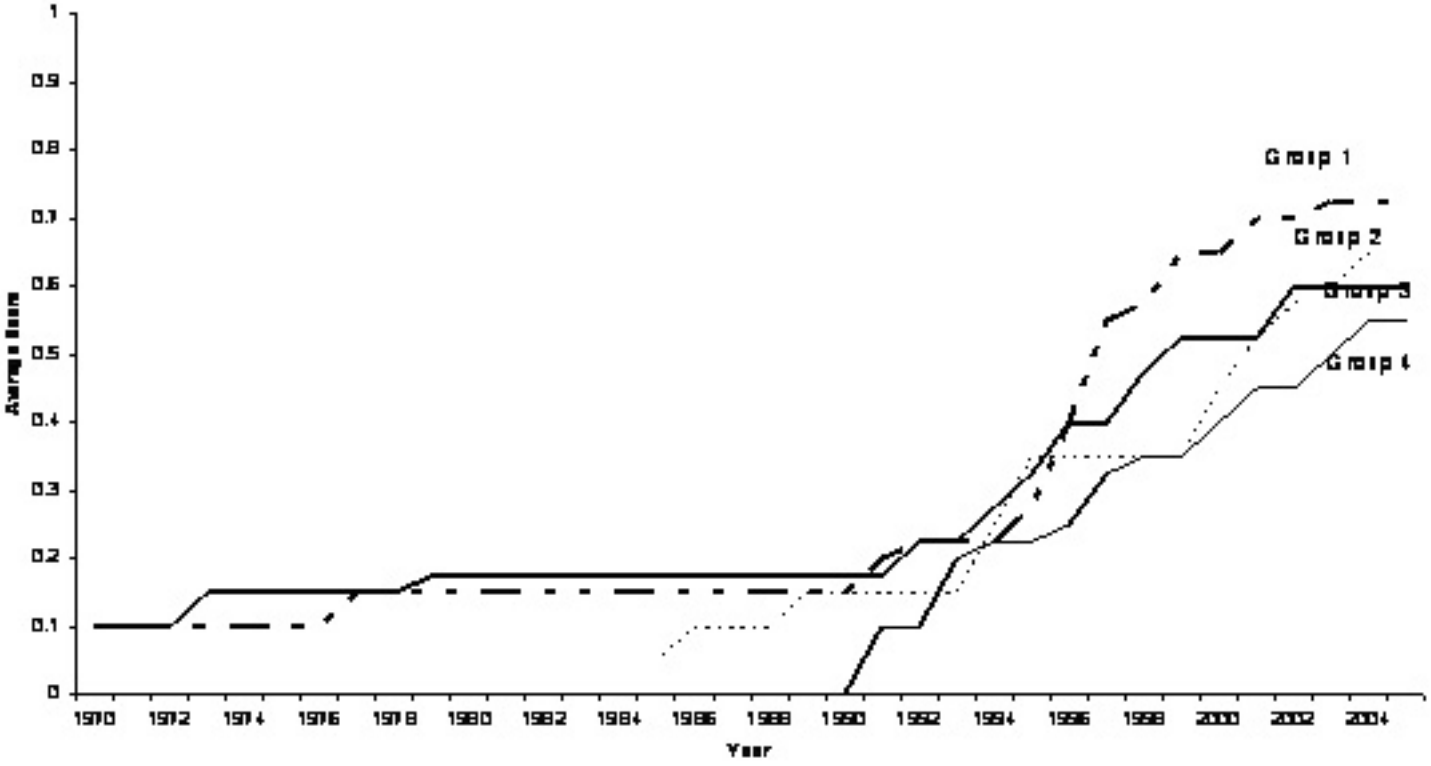
- The measurement of the role of the private sector in state–business relations is based on the presence and length of existence of an umbrella organisation linking businesses and associations together. It is possible to think of many other aspects and forms of business associations – the key is to come up with measurable aspects which can be compared across dimensions and over time.
- The measurement of the public sector in state–business relations is based on the presence and length of existence of an investment promotion agency (IPA) to promote business.
- Effective SBRs require the co-operation of the public and private sector, and one can examine a number of factors and forms : e.g. the number of different forms: it can be open to all and autonomous of government intervention as is the case with a formal existing body, or it can be an informal 'suggestive' body with no entrenched power. One possible measure of how the state interacts with business is based on the format, frequency, and existence of state–business relations.
- The presence and length of existence and effectiveness of laws protecting business practices and competition, measures the mechanisms to avoid collusive behaviour.

Of course there are other more refined measures on how the state and business sector communicate and interact, and these ought to be explored in detailed country studies. It is important to consider to what extent such measures can be objectively measured and can tell us about the relationship between state and business from an institutional point of view.

Measuring at the macro level

Each of the four factors above can be measured over time. In one background research, we focused on 20 African countries for which we have data on each of the four indicators. This leads to four indicators for each country and time-varying. A composite measure can use the average of the above indicators (attaching the same weight to each indicator, but this can be varied). Chart 1 plots the averages for four groups of countries, ranging from the fastest growing groups over 1970–2005 (group 1) to the slowest growing group (group 4). As expected country groups with higher SBR scores have grown faster. Detailed country studies should examine this in a more effective way and plot the measure over time.

Chart 1 Higher SBR scores for groups of faster growing countries

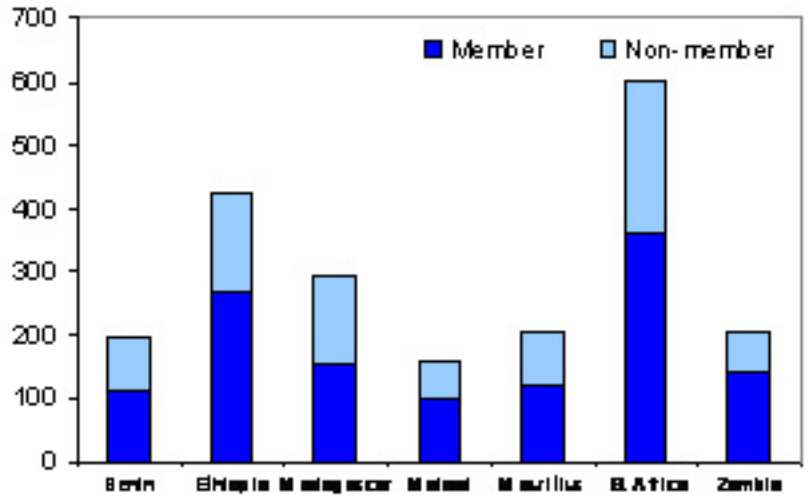


Notes: Group 1 = Botswana, Mauritius, Uganda, Mozambique, Mali; Group 2 = Tanzania, Ghana, Eritrea (part), Senegal, Kenya; Group 3 = Benin, Ethiopia, South Africa, Nigeria, Rwanda; Group 4 = Malawi, Zimbabwe, Madagascar, Zambia, Cote d'Ivoire. Groups based on PPP GDP per capita growth rates over 1980–2004.

Measuring at the micro level

One indicator associated with good SBRs is an organised private sector, which is measurable at micro level as membership. Chart 2 presents the distributions of firms that are members of business associations across 7 African countries. It would be important that this is done over time as well.

Chart 2: Private sector organisations membership across African countries (# of firms)



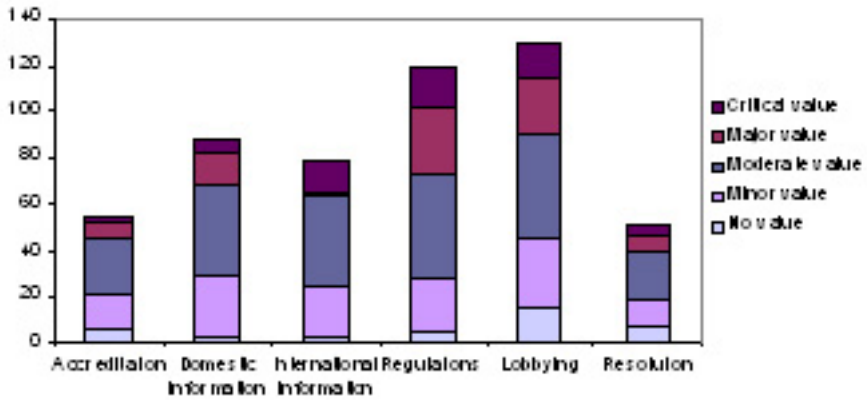
Source: World Bank Enterprise Surveys

We can be more specific. Business associations provide different services and the World Bank questionnaire asks firms which services are found to be the most important:

- Accreditation
- Provision of domestic information
- Provision of information on international markets
- Provision of information of government regulations
- Lobbying government
- Provision of support for conflict resolution.

In the case of Zambia, lobbying government and information on government regulations are on average the two most important services provided by business associations to the firms covered in the sample (Chart 3). The least important services are resolution of disputes (with officials, workers, or other firms) and accrediting standards or quality of products. The research also shows that business membership varies by sector and firm size; but all sectors and sized are covered.

Chart 3 Value of services by business associations to firms in Zambia



Source: World Bank Enterprise Surveys.

Indentifying the Effect of SBRs on Economic Performance

The identification of the effects of certain types of SBRs on economic performance is challenging because of at least three issues:

- Challenges in measuring SBRs (see previous section);
- Translating the role and economic functions into testable models (either econometrically or using a causal chain analysis where);
- Econometric issues such as potential endogeneity of SBRs to economic performance and the specification of economic performance (e.g. how is productivity measured, see note by other consortium members).

There are at least two ways researchers can proceed:

- Econometrically, using macro and micro models; or
- Case studies, where the effects of SBRs are presented using a causal-chain analysis

Econometrics: Macro level

Steps to undertake:

- Tabulate SBR measures (varying by state/country and over time)
- Assemble data on economic performance (e.g. growth or productivity)
- Formulate a testable model and address dynamics and endogeneity issues.

One example of a macro econometric approach (Sen and te Velde, forthcoming) used an index developed on the basis of measuring SBR (as detailed above in section 3) and estimates standard growth regressions in dynamic panel form for 20 African countries over the period 1970–2004, controlling for more conventionally used measures of institutional quality in the empirical literature. Estimations were done on the basis of GMM and fixed effects estimators. These suggest that effective state-business relationships contribute significantly to economic growth in Sub-Saharan Africa – countries which have shown improvements in state-business relationships have witnessed higher economic growth, controlling for other determinants of economic growth. The index of SBRs has advanced significantly and began to improve before the pick up in growth (though different conditions applied in different countries).

Box 2 Macro econometrics for SBR research

Sen and te Velde examine the effect of the macro SBR measure on growth independently of other factors that have been found to determine economic growth across countries and over time. It starts (in its most basic form) with the formulation of a growth regression in panel data form, with SBR as an additional explanatory variable:

$$Y_{it} = a_0 + a_1 Y_{it-1} + a_2 X_{it} + a_3 SBR_{it} + v_i + u_t + e_{it} \qquad (1)$$

Where *i* designates country, *t* designates time, *Y* is the logarithm of GDP per capita, and X_{it} is a vector of standard macro control variables. As is standard in the literature, it uses Government Consumption (as a ratio of GDP), Inflation (per cent) and Openness to trade, measured by Exports plus Imports as a ratio of GDP, as our initial control variables. The error terms v_i and u_t capture the time-invariant and country-invariant components of the error term, while e_{it} is the white noise component of the error term.

The panel has a long time dimension (T=34) and a relatively short cross-sectional dimension (N=19). In this case, the Least Squares Dummy Variable (LSDV) estimator is the preferred method, in comparison with the Generalised Method of Moments (GMM) estimator which is more appropriate when the cross-sectional dimension is larger than the time dimension. The GMM estimator could help to deal with instrumental variable estimation (and uses lagged variables) as it eliminates any endogeneity that may be due to the correlation of the country specific effects and the independent variables.

The above regression model is motivated by economic theory on how SBRs should affect growth but treats SBRs as a black box. However, it is also possible to examine economic functions at the macro level, see box 3

Box 3 Do good SBRs speed up investment climate reform?

It is possible to correlate SBRs variables with the various Investment Climate Indicators contained in the World Bank's Doing Business Reports over time and across countries. These indicators describe the difficulties faced by normal business operations, such as the number of procedures it takes to obtain licences, etc., export goods and services. Although some procedures are likely to be necessary, others could be streamlined. The hypothesis relevant for this paper is whether higher scores on SBRs would lead to a more streamlined administration (i.e. fewer regulations and time wasted when trading). Te Velde (2006) shows that that this is indeed the case for a cross section of the 20 SSA countries in 2005.

Econometrics: Micro level

Steps to undertake:

- Tabulate SBR measures (these need to vary by firm if only a cross section is available, or across time/sector/state if other dimensions are used);
- Estimate firm level performance / productivity;
- Formulate a testable model and address dynamics and endogeneity issues.

The micro-level studies follow a two-stage approach (although there may also be arguments for using a different estimation technique). In the first stage it estimates a production function to the firms in a country, by fitting a production function explaining production value added as a function of capital and labour. The estimation procedure could use the Levinsohn-Petrin technique to account for endogeneity of the error term and factor inputs labour and capital. Some data sets (such as the WB Enterprise Surveys) often include three years of firm performance data as well as variables such as material input costs required for LP estimation.

In the second stage, one can estimate a total factor productivity equation, where productivity is based on the residuals in the first stage. It is important to appreciate that there are different estimation techniques, each associated with pros and cons.

Micro level regressions for Zambia (Qureshi and Te Velde, 2007) used the enterprise survey data of the World Bank Group for around 200 firms with data on performance, including data that facilitate the calculation of productivity levels, and on the institutional context facing or perceived by firms. It finds that membership of a business association (a firm specific 0/1 dummy) enhances African (various countries') firm performance in the form of productivity improvements and is robust to including other variables. It is also possible to examine further, e.g. whether joining a business association is particularly useful for small and medium sized firms or foreign owned firms.

Micro level studies can also be employed to examine more precisely the economic functions of SBR when specific questionnaires can be used (ie questionnaires with detail on the role of business associations). For instance, Qureshi and Te Velde (2007) use a more detailed dummy variable than previously: e.g. when the business association provided specific information or services (rather than detailing whether or not the firm is a member of a business association) Detailed estimations for these African countries show that the effectiveness of business associations works primarily through solving of information related market and co-ordination failures and lobbying government.

The above regressions regard SBRs as a black box; a firm is a member of an association or not. In reality the effects of membership of business associations works through their economic functions such as the effect they may have on business climate indicators. For instance, it is possible to estimate the relationship between business association membership and the size of informal payments by individual firms and other investment climate indicators (equation 3 in Box 4).

Before/after or tracing studies

Discuss specific instances of effective SBRs, or ineffective SBRs (where appropriate back up with data analysis) on economic performance at macro at micro level. The importance is to show instances where the effects of state-business relations can be isolated as far as possible. It needs to discuss, measure and test hypotheses as formulated in section 3 above.

Box 4 Micro econometrics for SBR research

The micro econometrics begin with a simple Cobb-Douglas production function which links output with inputs and the firm's productivity, as follows:

$$y_i = a_0 + a_L L_i + a_K K_i + \varepsilon_i \ , \qquad \beta\varepsilon \quad (1)$$

where y_i is log of output measured in value added terms of firm *i,* and *L* and *K* are logs of labour and capital inputs, respectively. ε_i is the unobserved error term that represents the log of productivity shock or total factor productivity (*TFP*) of firm *i* and captures any effects in total output not caused by inputs or productivity. To investigate the effect of a firm's relationship with the government on its economic performance we estimate *TFP* from (1) and estimate the effect of SBRs (*SBR*) and several other factors identified in earlier literature to explain a significant proportion of the variability in TFP. We categorise the factors into two groups: characteristics of the firm (F) and characteristics of the investment climate (*X*), and estimate:

$$\log(TFP_i) = \beta_0 = \beta_s SBR_i + \sum_k \beta_{F_k} F_{ik} + \sum_j \beta_{X_j} X_{jk} + v_i, \qquad (2)$$

where v_i is a white noise error term, *F* includes firm characteristics such as the age, location, size and sector of the firm, and *X* comprises a number of investment climate indicators such as days to get a phone line, need to pay bribes, and power losses.

One channel through which SBRs affect firm performance is improved investment climate. Governments with good SBRs have a higher likelihood of adopting appropriate policies and reforms, while enterprises participating in state-business discussions are more likely to support these initiatives. To test this claim, one can estimate an equation linking SBRs to firm-level investment climate indicators, e.g.:

$$InvClimate_1 = \beta_0 = \beta_s SBR_i + \sum_k \beta_{F_k} F_{ik} + \sum_j \beta_{X_j} X_{jk} + \varsigma_i \ , \qquad (3)$$

where *InvClimate* refers to investment climate indicators such as the percentage of revenues paid as informal payments to government officials, percentage of total sales value lost due to power losses and insufficient water supply, availability of information and communications technology (ICT), and the average days required for custom clearance of export and imports. β represents the parameters to be estimated, ς is a white noise error term, and the remaining variables are the same as in (2). If SBRs improve the investment climate for firms, then β_S is expected to be positive and significant and vice versa.

The empirical evidence in the form of case-studies has drawn predominantly from East Asia and Latin America (see e.g. Doner and Schneider, 2000). Doner and Schneider provide some successful examples of market complementing functions of business associations:

- Schmitz has shown that trade fairs organised by Brazilian footwear associations were 'critical' to the 'ability to conquer distant national markets' and eventually to connect local to the North American market.
- During a market decline in the mid-1970s, the Thai Textile Manufacturers' Association (TTMA) promoted exhibitions , informed members about shifts in European demand, and urged members to increase exports to the EU prior to the establishment of baseline quotas.
- From its inception in the 1920s through the persistent international marketing campaigns of Juan Valde´z, Colombia's Federacafe´ has consistently brokered information between coffee exporters and importers. Federacafe´ even paid an employee in the Colombian consulate in Brazil to spy on its competitors.
- Korean associations reduced the costs of information about export markets, which not only reduced the entry barriers to volatile export markets but also helped to 'nationalise' exports by circumventing Japanese trading companies. Indeed, at one point, the export associations of each industry were 'the nodes for all information on exports.

African case-study evidence also supports the argument that well organised business associations can be important in pushing for growth-oriented policies. For example

- The Ivorian Chamber of Industry played an important role in arguing for policies supporting export-oriented manufacturing (Rapley, 1994).

- The Private Sector Foundation in Uganda is mandated to do policy research and advocacy for the private sector and has achieved improvements in the investment climate such as lower tariffs on key imports, upgrading of infrastructure and streamlining of public procurement (Badagawa, 2008).
- As Bräutigam et al. (2002, p. 526) notes, 'over the years, the JEC has become institutionalised as a strong and legitimate 'peak' association for businesses in Mauritius, an encompassing group that represents all the major sectors and works out broadly agreeable positions on economic policy'. The JEC discusses with the Minister of Finance a draft budget and presents proposals which to a varying degree are taken over in the final budget.

The key to such studies is that they describe how a business association fulfils certain economic function with growth enhancing effects.

SBRs and the Global Financial Crisis

The global financial crisis will have a major effect on developing countries' economies. There are two hypotheses about the relationship between the crisis and SBRs (we are not of course concentrating on the actual economic effect per se, but are interested in the institutional context):

- Slower growth might slow down institutionalisation because – as proponents of this view argue – good institutions are only formed when incomes are high.
- Alternatively, a shock of this proportion opens up new opportunities which constitute a critical juncture shifting the nature and focus of SBRs, which are otherwise slow moving. The current global financial crisis may provide an ideal testing ground.

The concept of the 'critical juncture' is used to identify moments when institutional innovation or change may be initiated or, at least, which create the opportunity for it to occur. Clearly, extreme events do occur which call into question existing institutional arrangements or allow for them to be changed. Some critical junctures may be internal or external, political or economic. The eruption of the global financial crisis is key critical juncture, as it is likely to fundamentally change the rules and regulatory apparatus governing the financial sector as well as the way state and business relate for some time to come. For example, do rapid changes in copper prices change the nature of state-business relations in Zambian mining or is it back to business as usual after variations in prices?

In practice, there are also new initiatives in developing countries. For instance, the current crisis has led to a sub-commission of NEDLAC (the formal SBR in South Africa). Ghana also set up a commission to monitor the impact of the crisis. Mauritius set up a task force which included the JEC. This also raises the question as to what type of SBRs can best respond to the global financial crisis, and the answer may well point towards those that are most institutionalised. However, it is also important to note that the crisis may challenge and even undermine the implicit bargains that form the foundation for specific SBRs.

The current global financial crisis is likely to lead to new insights into the determinants of SBRs, but it might also reveal other insights about whether and how certain types of SBRs are more flexible and better placed to respond to the crisis and help to get countries to grow and come out of the crisis.

If certain 'external shocks' are critical junctures and affect institutional structures then a carefully coded shock variable might be able act as an instrumental variable in the relationship between SBRs and economic performance.

Box 5 Mauritius: A pre-emptive strategy to address the global financial crisis

Mauritius has been quick to put in place new economic policies and build on an effective institutional framework for state–business relations, launching a stimulus plan in May 2008 worth 3.4% of GDP and an additional one in December 2008 worth about 3% of GDP.

The country benefits from an institutionalised setup to deal with the crisis. The Prime Minister set up two Ministerial Committees in November, 'Nurturing Resilience' headed by the Prime Minister and 'Human Capacity, Solidarity and Physical Infrastructure' headed by the Vice Prime Minister and Minister of Finance. After the additional stimulus package was announced, a Committee was set up, co-chaired by the Secretary to the Cabinet and the JEC, the private sector co-ordinating institution.

Conclusions

This note has discussed some methodological issues in examining the economics of state-business relations. It discusses economic theory on how state-business relations can affect growth. It then covers empirical research methods to estimate the effects, which depend on measurement of SBRs (Section 3) and an appropriate estimation and identification strategy (Section 4). Section 5 discusses how the global financial crisis affects the research on SBRs, both in terms of possible changes in the institutional set-up which can affect economic policies and in terms of econometrics.

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