Introduction and overview

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This collection of essays by internationally distinguished scholars discusses the nature of state-business relations (SBRs) and the links between SBRs and economic performance. It is generally accepted that economic growth directly depends on economic fundamentals such as skills and capital formation as well as the efficiency through which factors of production are put together. But beyond this, the briefings in this publication all bring out that the nature of state-business relations is a crucial factor behind efficient skills development, capital formation and ultimately higher productivity and incomes. But there is considerable debate about how the effects work, whether current state-business relations are conducive to or hamper economic performance, and about how the nature of state-business relations conditions the conduct of more active policies encouraging economic growth.

This study is the result of the work of researchers linked through the Research Programme Consortium for Improving Institutions for Pro-Poor Growth (IPPG) which conducted research from 2005-2010. The study of state-business relations (SBRs) was at the heart of the Consortium. Relationships between states and business are usefully understood as giving rise to and reflecting both economic and political institutions. Economic, because SBRs embody formal and informal rules and regulations that are designed to perform economic functions, such as solving information-related market and coordination failures, and hence will affect the allocative and dynamic efficiency of the economy. Political, because SBRs reflect the way in which power among different agents, elites and coalitions of interest is shared. This manifests itself in both formal and informal institutional arrangements between the private sector (e.g. business associations, including organised farmer groups) and the public sector (e.g. different ministries or departments of state, politicians and bureaucrats). IPPG devoted one of three clusters of work to the study of SBRs covering sub-Saharan Africa and India.

Over the past few years, several further studies have examined how the government can support growth, either conceptually or in practice. Although their main focus may not be on institutional aspects, they complement the IPPG analysis extremely well. This includes other work at the Overseas Development Institute (ODI), the Institute of Development Studies (IDS), the German Development Institute (DIE) and the World Bank not funded by IPPG.

This publication consists of three main parts. Part A introduces theoretical aspects of the study of SBRs. Part B examines two technical and methodological aspects that have been at the forefront of the study of SBRs: how to measure SBRs and how to deal with endogeneity concerns in the relationship between SBRs and economic performance. This part is designed specifically for quantitative specialists. Part C discusses the findings, evidence and policy suggestions of IPPG research on SBRs and major work related to SBRs. A set of conclusions follows.

Chapter 1 by Te Velde argues that 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 through cooperation, and can reduce policy uncertainty. Te Velde suggests that, 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.

Chapter 2 by Lin draws on recent work on a new structural approach to economic development and outlines a path towards an optimal framework for SBRs. He suggests that establishing successful SBRs requires an appropriate policy framework which allows the state to support industrial development and technological upgrading but which also minimises opportunities for rent seeking. He argues that countries that succeed in adopting and implementing such frameworks are those where government's industrial development goal is consistent with its comparative advantage, which reflects the accumulation of human and physical capital and the change in its factor endowment structure.

Chapters 3 to 6 discuss methodological and technical aspects in the study of SBRs. Chapters 3 and 4 discuss the measurement of SBRs in Africa and India respectively. Chapter 3, by Te Velde, goes to the heart of the discussion among political scientists and economists studying SBRs, asking whether it is possible to measure SBRs meaningfully. SBRs are not always directly observable, yet we still want to assess their importance for economic performance. Te Velde provides a number of examples of measuring SBRs based on objectively measurable characteristics of good SBRs suggested by political science. He constructs SBR measures for 20 African countries over three decades, measuring the organisation of business and government actors, the fora that bring the two sides together and a set of competition principles ensuring absence of collusive behaviour. Calì, in Chapter 4, measures SBRs using observable variables at the state level for India over time. The resulting state-level measures show commonalities and differences with conventional investment climate measures.

In Chapter 5, Te Velde discusses endogeneity issues. When relationships are behavioural, observing a correlation between two variables without additional information is normally not enough to infer causality. For example, a firm can join a business association, which in turn can promote better firm performance, or, for some reason (or characteristic), good firms self-select themselves to join a business association. Both of these lead to a positive correlation between membership and firm performance. It is important for policy to understand which direction the correlation goes in. Te Velde suggests three ways used in the Africa research to address endogeneity issues: data, economic theory and specific methods such as instrumental variables estimation or the Generalised Method of Moments (GMM). Chapter 6 by Calì, dealing with the research on Indian states, suggests two new and innovative instruments that can be employed in instrumental variables estimation, drawing from India's political history: one based on land reform legislation enacted by Indian states at different points in time and the other based on the nature of the political regime in a given state. As such variables help to explain the nature of SBRs, they can deal with endogeneity issues.

Chapters 7 to 11 discuss findings and provide policy suggestions. In Chapter 7, Altenburg presents findings of a seven-country study on the role of industrial policy. He suggests that selective industrial policies may work even in countries with limited government effectiveness. The risk of failure is high, however, especially when strategic decisions are taken without sufficient involvement of the business community. Strategies to move on to higher-value activities within existing value chains look quite plausible, but they have rarely been successful to date. In most cases, the countries have lacked competitive advantages in the targeted upstream or downstream industries. Shifting to more demanding activities is a difficult task that requires a deep understanding of industry conditions. Altenburg argues for policies which are closely coordinated with the private sector, which encourage experimentation and which support innovative risk takers. Regular feedback loops with market actors to fine-tune sector strategies are important.

In Chapter 8, Te Velde discusses the findings of four African case countries on SBRs conducted by African IPPG researchers. The studies discuss the economic functions through which SBRs affect economic performance, such as affecting the allocative efficiency of government spending and industrial policy. Te Velde suggests that the studies have a number of policy implications, including the need to build capacity to conduct meaningful SBRs, ensuring buy-in from all actors to the effective functioning of SBRs and putting the spotlight on informal SBRs where they are not functioning well.

In Chapter 9, Ellis summarises ODI research which suggests that the relationship between government and large businesses is often more important in determining market outcomes than competition and market forces. This mutually beneficial relationship between government and business underpins the formation of a powerful economic elite, with vested interests in opposing pro-competition and pro-growth reforms, which has serious consequences for economic development more broadly. In this situation, it is the relationship between a business and the government that often seems to determine a company's commercial success in a country, rather than market forces, and this is likely to have significant economic costs. This is a useful reminder that SBRs need to be disciplined by a set of competition principles, or risk becoming collusive rather than collaborative.

Sen in Chapter 10 discusses how a harmful collusive relationship turned into a more collaborative relationship in India in the mid-1980s and early 1990s, and how this affected different states differently. IPPG research has shown that variations in regional institutional quality captured by the quality or effectiveness of SBRs can explain variations in economic growth in Indian states. For the Indian state of Andhra Pradesh, IPPG researchers identify the coming to power of a chief minister of the state government in 1995 as the 'critical juncture' that explains the rapid improvement in SBRs in the state and its subsequent successful record in economic growth. The Andhra Pradesh case study highlights how leaders and elites can work to form positive growth or developmental coalitions.

In the final substantive contribution, Chapter 11, Abdel-Latif and Schmitz discuss work conducted through IDS on the impact of SBRs in Egypt. They suggest that SBRs, featuring active cooperation, helped investors to overcome barriers to economic growth and policymakers to overcome deficiencies in their own government agencies, and helped both sides to work together in establishing new sector-specific rules and improving the general regulatory framework. The authors argue that informal SBRs are not necessarily all bad and can be strong growth enhancers – but a setting must be created that avoids corruption and maximises inclusiveness through an organised private sector, strong monitoring agencies and free media; and that the focus of industrial policy needs to be more on how to implement the policies than on what policies to adopt: SBRs featuring active cooperation can be very effective.

Te Velde concludes with a set of key principles on SBRs.

IPPG is supported by UKaid from the Department for International Development
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