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Business Associations, Business Climate, and Economic Growth: Evidence from Transition Economies

Paper at a Glance

- The link between business associations and economic growth in the transitional economies of Central and Eastern Europe is re-examined through the prism of new institutional economics.
- By promoting a better business climate, market-enhancing business associations can help to build the foundation for economic growth.
- The Center for International Private Enterprise's (CIPE) seven-step reform agenda process is a powerful tool for advancing business associations' participation in policy making.
- Case examples from CIPE programs in Romania and Russia illustrate how associations can solve the collective action problem.

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The Center for International Private Enterprise (CIPE) strengthens democracy around the globe through private enterprise and market-oriented reform. CIPE is one of the four core institutes of the National Endowment for Democracy and a non-profit affiliate of the U.S. Chamber of Commerce. Since 1983, CIPE has worked with business leaders, policymakers, and journalists to build the civic institutions vital to a democratic society. CIPE's key program areas include anti-corruption, advocacy, business associations, corporate governance, democratic governance, access to information, the informal sector and property rights, and women and youth.

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Introduction

Interest groups are rarely portrayed in a positive light. In economic theories of regulation, collective action, and rent-seeking, interest groups are commonly perceived as seeking some form of redistribution through a political process. For example, the economic theory of regulation advanced by Stigler[1] and Peltzman[2] has been called the capture theory of regulation to reflect the idea that interest groups exert influence over policymakers, effectively capturing the legislative process.[3] Although Olson's[4] work on the logic of collective action concentrates on the inner-workings of interest groups, it also develops a rather negative view of such groups as seeking protection for members, leading him to later declare[5] that interest groups stifle economic growth in societies where they proliferate. A few theories argue to the contrary; interest groups can be beneficial in the provision of public goods in instances where markets fail to provide them.[6] However, interest groups in the private sector – business associations, chambers of commerce, trade groups, and others – are most commonly portrayed as lobbying for some set of benefits for their members at the expense of other groups, whether they are subsidies, trade protection, or price breaks.

The transition process in Central and Eastern Europe in the late 1980s to early 1990s brought to the forefront a new set of questions in regards to the role that interest groups can play. As countries began to explore free markets and mechanisms to put them in place after decades of command-style economic disasters, private-sector interest groups emerged as primary participants in this process. In some instances, state-created chambers of commerce acted as guardians of insider firms' interests in the political process. In others, newly formed business organizations sought ways in which they could solve the collective action problem and engage the nascent private sector in the policymaking process.

The success of these countries that restructured fundamental institutions and built new ones is becoming increasingly evident.[7] For example, countries in Central and Eastern Europe are rapidly moving towards full integration with the global economy, while Central Asian countries and some other former Soviet Republics are increasingly isolated. In many cases, private-sector interest groups were participants in successful reform efforts. Acting as the liaison between policymakers and economic agents, business associations and chambers of commerce channeled information and reform recommendations from businesspeople, facilitating the development of a business-friendly environment. These associations emerged as engines of economic growth and development, seeking to increase the size of the economic pie through the political process, rather than simply trying to capture a larger share at the expense of others.

This paper explores how firms, represented by business associations, can provide information and create political support for rules that foster a better business climate. Global criteria used by the Center for International Private Enterprise (CIPE) is presented to identify market-promoting interest groups and a process to develop a business-friendly policy environment. A further look into the case studies of market-promoting associations in Romania and Russia provides concrete examples.

A collective action problem

Before the market transition, in Central and Eastern Europe and the former Soviet Union countries, there was typically a relatively clear division of economic agents. There were those who had access to the system and those who did not. Less efficient producers could obtain a more favorable application of laws based on their relationship with authorities. That is, the classical notion of a marketplace governed by the fair application of rules and regulations did not apply. In places where outright favoritism in rule-making and implementation continued to predominate during the market transition, crony capitalist systems emerged. Such systems resembled some features of modern capitalist systems, yet lacked the fundamental principles of fairness and transparency. They gave rise to business groups or individuals, such as the Russian oligarchs, who, through close-knit relationships with policymakers and bureaucrats, enriched themselves while destroying the competitive potential of the economic systems within which they operated.[8]

The lesson from these distorted market transitions is that macro-level reforms, while important in their own right, cannot suffice without reforms on the micro level. Of particular importance is the development of a good business climate, within which private sector activity flourishes, entrepreneurial potential is realized, and efficient contracting and enforcement of property rights contribute to higher productivity, job creation, and overall economic growth. A bad business climate results not only in the general inability of firms to attract investment, but also leads economic agents to expend valuable resources on overcoming regulatory burdens rather than on productive activities.

Across transition countries, although there was a high demand for rules that would sustain a good business climate, the political will to create such rules was often lacking. To fill that void, new mechanisms for policymaking had to be created so command economies and their variants could be replaced with market-oriented institutions. In part, this required changes in political institutions and legislative practices toward increased efficiency, responsiveness, and transparency. However, much of the momentum for reform and the information for sound rule-making needed to come from business firms. The majority of private firms shared a collective interest in obtaining fair, efficient market rules. They faced a collective action problem in forming associations that could press for the creation of a market-oriented, business-friendly environment.

Note that there is a key distinction between market-promoting and redistributive associations. Certainly, not all business associations are advocates of free-market reforms. Some associations may act as vehicles for business groups to capture the state, for example. These types of business associations act as barriers to, not facilitators of, economic reform. Other types of associations, particularly those based on the continental mandatory membership model of associations, have few incentives to address the institutional deficiencies. Those types of associations act more as quasi-governmental service providers.

On the other hand, voluntary membership-based associations are often much better candidates to advocate for institutional reforms, given their freedom from dependency on governmental revenue and greater incentives to represent the interests of their members. Voluntary business associations can act as 'the voice of business,' bringing the issues companies face on a day-to-day basis and possible solutions to those problems before policymakers. Most voluntary associations develop an internal policymaking process to identify issues of concern, discuss and debate possible positions on how the issues should be addressed, and formulate a consensus among member representatives on the association's advocacy position. This process can be thought of as a form of internal democracy. Within the associations, the policymaking process culminates in a board of directors that is representative of the interests of the underlying membership. Frequently, where membership interests cannot be unified, particularly in the peak form (or encompassing form) of associations such as the U.S. Chamber of Commerce or the German Federation of Industry, the association declines to become involved in an issue and leaves it to sectoral organizations to address.[9]

Painting all interest groups with the same brush is a mistake. Different groups pursue different agendas and have different effects on economic, social, and political institutions. For the purpose of this analysis, it is useful to focus on two main categories: market-promoting associations and redistributive associations. The key difference between the two is that redistributive groups seek to shield their member companies from competition by, for example, erecting trade barriers, thereby limiting market function. Market-promoting associations, on the other hand, seek to improve the market function by supporting measures to improve contract enforcement or reduce transaction costs in the form of business registration procedures. One cannot say with certainty *ex ante* which associations will pursue which of these behaviors. However, the governance structures of associations and their member firms' interests will shape the actions of association leadership: to seek rents, provide member services consistent with fair market competition, or create new market-oriented rules.

Constructing a reform agenda

In many cases, redistributive associations exceed market-promoting associations in numbers and strength. CIPE identifies and strengthens voluntary, market-oriented associations and helps them assume the role of engines of economic reform. CIPE's advocacy tools help these elements of the private sector identify common concerns, provide information to policymakers, and develop proposed solutions. These are employed together in a seven-step process known as a reform agenda. Although intended for practitioners, the process illustrates the dynamics of constructive participation by business associations seeking better policies and not rents.

Step 1. Identify the initial conditions

What are the most important barriers to market entry and what are the true costs of doing business? Determine the facts on the ground – the issues and barriers being experienced by the entrepreneurial sector. A survey of the investment climate is one option. Publicize these findings in both the financial and popular press.

Step 2. Locate key points of change

What are the institutional reforms that will generate a private sector supply response and benefit business, the economy, and society as a whole? When there is a crisis, it is sometimes possible to take a holistic approach. Estonia is an excellent example of a country that implemented fundamental reforms that transformed the system through a currency board, privatization, and comprehensive tax reform. Conversely, János Kornai's recent work shows that sequential reforms in countries like Hungary had the same cumulative effect through a process of incrementalism.[10] It is important to identify institutional changes that are feasible and will actually benefit entrepreneurs, workers, and citizens.

One way of identifying small changes that will produce systemic change is a technique known as the national business agenda. Key points of change are identified through focus group meetings held with representative businesspeople throughout a country. CIPE has worked with groups in countries as diverse as Egypt, Peru, and Russia to carry out such programs.[11]

Step 3. Mobilize for collective action

Business associations, think tanks, and other civil society organizations must mobilize to join in collective advocacy for institutional reforms. In some countries, the principal business associations, often including the chamber of commerce, are under the direct or indirect control of the government. However, it is possible in nearly every country to identify countervailing associations that represent the interests of smaller firms, firms with an interest in access to the international system, and others who want to see a free market economy develop. In addition, think tanks or public policy institutions that aim to develop democratic, market-oriented economies have developed in many countries around the world.[12]

Step 4. Generate policy recommendations

Business groups should generate specific policy recommendations such as reductions in entry barriers, reform of customs procedures, or simplification of tax administration. Actually formulating specific reforms that can address the issues identified above requires both creativity and some degree of expertise in policy analysis. These recommendations should be as specific as possible. Reformers should resist the temptation to simply say, for example, that the tax system needs to be fundamentally reformed. Is it a reduction in the level of taxes, a simplification of the tax payment system, or the outright elimination of some portion of the types of taxes?

Step 5. Manage expectations

Reformers should set achievable goals that can demonstrate to business constituencies and the public that reforms *can* be achieved. Holding a coalition of associations, think tanks, and others together requires a sense of momentum. People need to feel that their efforts are having an effect and that further progress is possible. In times of normal politics (absent a crisis or change of system), setting some specific and important goals for reforms helps maintain this momentum. It is also important to be realistic about what it will take to accomplish the coalition's goals.

Step 6. Mount an advocacy campaign

A reform coalition should mount an aggressive advocacy campaign that effectively communicates complex ideas in simple and attractive ways to build the case for policy reforms. Each policy reform must be well-researched and fully developed to demonstrate to policymakers, the media, technocrats, and the international community that the reforms are viable and in the best interest of the country. In some cases, this may involve sophisticated economic research and analysis. In others, the issue may be so clear-cut that extensive research is not entirely necessary, but the analysis and presentation still must be completed and made available to the public. The advocacy campaign has to take these analytical materials and transform them into simple public policy messages that take into account the practical politics of decision-making.

Step 7. Recognize leaders who act

Finally, it is vital to recognize government officials, political leaders, and businesspeople who actually implement the policy reforms. While this may seem obvious, it is often forgotten that politicians and others need public acknowledgement of the roles they have played. In both new and established democracies, the incentives for policymakers to advance reforms are votes, funding, and publicity.

The following case studies, based on CIPE's work in Romania and Russia, illustrate the benefits and challenges of participation by private sector interest groups in market-oriented policy reforms. CIPE worked with some of the more reform-oriented associations to develop their capacity to solve the collective action problem. Associations were strengthened through the provision of selective incentives in the form of services to member firms that complemented rather than distorted markets. At the same time, CIPE assisted associations and think tanks in developing policy solutions, communicating information to policymakers, and forming coalitions to back collective solutions.

Romania[13]

Business climate

Romania was slow to build the foundations for private sector growth. Private enterprises became legal in 1990 but languished in a difficult institutional environment. Red tape, corruption, inadequate access to information, and underdeveloped markets thwarted emerging entrepreneurs. The informal sector represented as much as 25 percent of the economy. The government accelerated reforms in 1997, including privatization. Yet, it continued to favour state-owned enterprises, especially inefficient heavy industries, at the expense of smaller private companies. Private businesses faced unfair competition from the state sector, which often monopolized information, raw materials, and energy. Romania had "become a leading example of the perils of special-interest politics:"

> Far from providing entrepreneurs with the conditions needed to operate freely and profitably, the Romanian government continues to develop legislation that favors established interests [that] can circumvent the democratic process at the expense of small and medium entrepreneurs who struggle to have their voices heard in policy development circles.[14]

A congeries of independent business associations formed to pressure the government to remove restrictive or contradictory laws as well as create new laws and policies that would nurture entrepreneurship and a market economy. These associations were too divided to articulate or promote their common interests and were weakened by competition from established chambers of commerce, which tended to be aligned with the state sector. CIPE performed a diagnostic evaluation of over 20 business associations in July 2000. More than 60 percent of associations had limited, if any, involvement in the public policy arena; the remainder focused on sector-specific issues. The business community, including some business associations, tended to rely on influence within government rather than policy advocacy.

Association advocacy

From 2000 to 2003, CIPE helped transform Romania's private sector associations and through them the business climate by strengthening the associations themselves, facilitating coalition building across associations, and introducing advocacy techniques. In 2002, CIPE brought together a number of its Romanian partners in the Open Doors Advocacy Campaign. This coordinated initiative involved three coalitions representing distinct economic sectors, which compiled their recommendations into a single policy document and pursued a joint campaign.

The groups identified and prioritized general issues such as corruption, bureaucracy, taxation, overregulation, freedom of information, and lack of transparency. Each of the three coalitions also identified and prioritized issues for their respective sectors. For example, firms in the tourism industry were opposed to the 3 percent tourism tax assessed on top of the 19 percent value added tax. They also wanted the government to set up regional tourism bureaus. The information technology and communications sector sought a reduction in employee taxes for IT firms, as well as the creation of an information technology park. The light manufacturing sector was concerned about the high level of taxation on profits (21 percent) and high export duties, and also desired a labor code that was fair to employers and employees alike. Each coalition unveiled its legislative agenda in a press event featuring senior government and business leaders.

The coalitions then launched a grassroots advocacy tour of 10 cities to create support for their legislative agendas. This advocacy tour not only generated a great deal of positive press, it convinced many government officials that popular support could be obtained for the reforms necessary to rejuvenate the economy. The Open Doors Campaign garnered over one thousand individual signatures from business leaders and 40 supporting organizations with an aggregate membership of more than 3,000. Following through on the advocacy tour, the coalitions held Advocacy Days in 2002 and 2003, during which a total of 300 business participants had the opportunity to meet with government officials and attend public hearings. These events highlighted the importance of public involvement in policy decisions, transparent legislation, freedom of information, and accountability in government. The campaign generated pressure on policymakers to respond to an informed, representative, and transparent set of business recommendations of wide significance to the economy.

Outcome

Largely due to the efforts of business association advocacy within the framework of the Open Doors Campaign, Romania passed a Freedom of Information Act. Several ministries embraced initiatives to systematically reduce unnecessary bureaucratic constraints. Further, the Ministry of Small and Medium-Sized Enterprises (SME) approved development of a strategic plan for SME competitiveness. Thirteen specific changes to the Romanian Labor Code, recommended by a panel of experts after input from a public hearing, were submitted to the Minister of Labor. The minister agreed that the recommendations were appropriate and established a private sector task force to analyze sections of the law prior to the creation of the implementation norms.

Coalitions for the individual sectors also obtained many of the changes they wanted. The Ministry of Tourism approved the creation of regional tourism bureaus, which within a year after their formation were already generating hundreds of thousands of dollars through their promotional activities. Also, the 3 percent Special Tourism Tax was cancelled as of June 2003. The government passed a law to create three technology parks. Employee taxes for information technology workers were reduced and within 18 months Romanian IT companies had added over 1,500 new jobs. In the manufacturing sector, the coalition obtained amendments to the labor code that it had sought.

Reforms advanced by the Open Doors campaign created an estimated 2,850 jobs and over $10 million in economic growth, not counting the effect of the reduced tax regime on tourism and information technology companies. From 2002 to 2003, wages rose in the information technology industry by nearly 38 percent, in the tourism industry by 28 percent, and in light manufacturing by 18.6 percent. Industry experts acknowledged that changes in laws, many of which were proposed by the coalitions in the Open Doors campaign, led to these wage increases.

The Reality Gap in Russia

Activity	Legal Mandate	Reality
Registering a Business	5 days	26-29 days
Registration Cost	2,000 rubles	4,692 rubles
Number of Offices Required to visit	One	Three
Licensing Costs	Not to exceed 1,000 rubles	16,600 rubles

Source: CEFIR and World Bank Survey, 2002

Russia[15]

Business Climate

Since 2002, the Center for Economic and Financial Research (CEFIR) in Moscow has measured the barriers to doing business faced by firms. It has consistently reported a gap between what the law stipulates and what entrepreneurs actually experience when dealing with government agencies. As can be seen from the following table, the old Russian proverb 'trust but verify' continues to be applicable. The difference between the law on the books and the law in day-to-day life can be the difference between successful reforms and a façade of progress.

In 2003, the Chamber of Commerce and Industry of the Russian Federation (RCCI) identified a similar set of problems. Registration, licensing, certification, and complicated tax codes frequently prevented the launching of business operations, provoked businesses to 'escape' into the informal sector, or even shut them down entirely. Frequent changes in laws exacerbated confrontations between the small and medium-sized entreprise (SME) community and government agencies for audit, reconciliation, and oversight. Inspectors extracted bribes from businesspeople, who found judicial remedies highly inefficient. Property rights, too, rested on shaky foundations. Although many factories and buildings had been privatized, the land on which they rested was still owned by regional or municipal authorities intent on maintaining a revenue stream from rental payments.

Association Advocacy

Hundreds of voluntary associations and chambers of commerce emerged in the 1990s. In a survey of the associations, Pyle[16] found they offered diverse, market-supporting services such as innovation and investment services, provision of information, training and recruitment services, and trade promotion.[17] Their member firms tended to pursue market-oriented restructuring and investing at a higher rate than those that did not belong to an association.

One of the larger coalition-based advocacy campaigns to generate reform is a partnership between RCCI, the Russian Union of Business Associations and CIPE. Since national law was not being implemented by local administrations, the partners determined that creating grassroots coalitions at the local level could create demand for implementation. They calculated that successes in the administrative regions could be used as evidence that further changes were needed at the national level.

Coalitions were formed that included local think tanks, business associations, and like-minded civil society organizations interested in creating a better business climate. Based on focus groups, regional business agendas were laid out for eight different regions of Russia. Participants worked in small groups with colleagues from their region to identify common obstacles and key development objectives. They then mapped out strategic coalitions to address individual issues. The business agendas they created identified very specific barriers and proposed very specific reforms to deal with those barriers.

Outcome

The results attained demonstrate the cumulative power of collective action. Many administrative barriers were reduced when the Krasnodar region governor signed a single-window decree simplifying land transactions. Although the number of required documents remained at 20, the time for reviewing the documents was reduced from a period of 6 to 24 months to a period of 2 to 6 months. The mayor of Khabarovsk signed a similar decree on November 30, 2003 introducing a single-window procedure for small-business registration. This decree reduced the time for registration procedures from 30 days to between 7 and 15. The Primorsk Coalition reduced the number of documents required to register a business from 7 to 1 and the time to register from 40 days to 7. Similar kinds of reforms were put into place in the area of inspections, information, property and leasing, finance, taxes, and capacity and services. The impact of these reforms was a 45 percent growth in coalition membership during the project period. As each reform policy was implemented, others could see that it was having a positive effect and joined the reform effort.

The coalitions' recommendations were incorporated into a federal law signed by President Putin on the SME taxation systems, which reduced the list of business activities that require licensing from 125 to 103, extended protection of property rights, gave entrepreneurs the right to challenge inspections by state licensing bodies, and guaranteed protection to SMEs in state contracting competitions. There was also a growing recognition and acceptance of the business community's constructive role in the policymaking process.

Conclusion

In his speech at Harvard University, Dani Rodrik asked a fundamentally important question: "How are good institutions acquired?"[18] echoing the concerns of other scholars of new institutional economics, such as Douglass North.[19] While the necessary tools exist to identify good institutions – institutions that countries must have in place in order to achieve high-quality economic growth – still little is known about how such institutions emerge or how they are developed.

Business associations can play a key role in the process and path of institutional development in some transitioning economies. CIPE's experience in more than one hundred countries shows that there must be a healthy mix of international experience and local knowledge in generating institutional reforms. An emphasis on local realities is important, since initial conditions and key players differ. No two countries share the same mixture of resource endowments, institutional arrangements, leadership capacity, or private sector actors.

Not all business associations are the same. Olson was not necessarily wrong when he concluded that interest groups can stifle economic growth. However, he presented only one side of the equation. The other side is that collective action problems can be solved in market-enhancing ways, where the end result is an improved business climate and expanded market opportunities for wealth creation. Findings by Pyle[20] and Marer[21] confirm that business associations can, in fact, have a positive impact on the development of markets.

There is a battle between market-enhancing and rent-seeking interest groups and the side that gets the upper hand in policy reform can have a significant impact on countries' economic fates. Where rent-seeking organizations predominate, Olson's predictions will hold, as studies on state capture, corruption, weak governance, and crony capitalism conclude. Yet, if market-enhancing private sector organizations succeed in creating a good business climate through bottom-up, participatory policymaking, then countries have a much better chance of generating long-term economic growth.

It is crucial to blend politics and economics to ensure the success of market reforms. Lack of political will to reform and weak governance mechanisms can significantly reduce the potential of conventional economic reforms to take root and deliver as theory predicts. Democratic governance is a key part of designing policy and implementing changes. It employs transparent policymaking, where key information flows from economic agents to policymakers and where individuals in government and the private sector can be held accountable for their actions. The advantage of democracy over an authoritarian regime is the replacement of the central planner in the creation of market rules with market agents themselves through representative institutions.[22] Successful reforms also require responsible private actors. Ethics and leadership play a very significant role in getting firms to commit to a functional rule of law system, where the ultimate reward is a stable, competitive, and predictable business-friendly environment. Voluntary business associations are a primary vehicle through which ethical business leaders can and do serve these broader interests.

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Notes

[1]Stigler, 1971.
[2]Peltzman, 1976.
[3]See also Hellman et al., 2000a.
[4]Olson, 1965.
[5]Olson, 1982.
[6]For instance, Doner and Schneider, 2000; Schneider, 2004.
[7]Johnson et al., 2000; Svejnar, 2002.
[8]For more on state capture see Hellman et al., 2000b.
[9]The above definition might be thought of as an 'ideal type' in the sense used by Max Weber. For more information on different models of national chambers of commerce, see Pilgrim and Meier, 1995.
[10]János Kornai, 'Presidential Address,' delivered at the 14th World Congress of the International Economic Association in Marrakech, Morocco, on August 29, 2005.
[11]The National Business Agenda Guidebook is available at www.cipe.org/publications/papers/pdf/NBAGuidebook.pdf.
[12]See McGann and Weaver, 2000.
[13]Anton, 1994; Anton, 1998; Center for International Private Enterprise, 2003; CIPE, 2005; Grecu and Pascal, CIPE, 2006.
[14]Anton, 1998: 23.
[15]Center for Economic and Financial Research, 2005; Pomeranz, 2004; Pyle, 2005; CIPE, 2006.
[16]Pyle, 2005.
[17]See also Pyle, 2006.
[18]Rodrik, 2000.
[19]North, 2003.
[20]Pyle, 2006.
[21]Marer, 1999.
[22]Much of new institutional economics, beginning with Ronald Coase and Douglass North, is concentrated on this problem of how to create systems of feedback and accountability to create incentives for sound economic policy (North, 1990).