

1. Title:**The Politics of State-Business Relations and Consequences for Development Trajectories – A comparative project on Egypt, India, South Africa and Turkey¹****Summary**

The proposed research will involve a mixture of within-case and cross-case comparisons of state-business relations. This will start from an interpretation of the overall political settlement, with particular attention to the arrangements between political and business elites, and the political mechanisms that ensure sufficient support (or lack of challenge) from middle and poorer groups. This will be at the national level for Egypt, South Africa and Turkey, and at the subnational level for India, where the focus will be on a subset of relatively dynamic states (Andhra Pradesh and Tamil Nadu, plus one other, probably Gujarat or Karnataka.) It will assess how the mechanisms of interaction between politicians and business support a political equilibrium. Then a central focus will be on the relationship between politician-business relations and firm level dynamics, using a mixture of econometric analysis of firm-level data sets and sector cases studies. This will in particular explore the extent to which state-business relations are associated with competitive business dynamics as opposed to collusive rent-sharing—and also where rent-sharing is aligned with positive business development. The focus is on emerging middle income countries that have experienced some business dynamism, in a variety of political settings, including competitive democracies, and dominant parties under formal democratic and authoritarian auspices. A broader interest is whether there is a general tendency for these growing middle income countries to get stuck in a “cronyist trap” and/or be subject to populist resolutions to meet the political aspirations of middle and poorer groups. We also see this as a contribution to the literature on varieties of capitalism. The implications for policy will both explore potential institutional design resolutions (for dynamic capitalism and inclusionary development) and the political circumstances in which these may be explored.

2. Background and objectives:

Extensive state-business interactions are an essential part of the development process, in poor and rich countries alike. These can form the basis for dynamic capitalism and demands for an

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effective state, or can become sources of influence, corruption and other forms of rent-seeking, that distorts politics, regulation, judicial functioning and business incentives.

Most successful cases of long-run economic growth have occurred in circumstances where states have encouraged business to have the confidence to invest by providing the incentives, the institutions and the public goods (economic, social and political) which enable them to do so. This has been done in ways that prevented collusive rent-seeking amongst state and business actors from having major systemic effects that undercut dynamism. The creation of rents and various forms of rent-sharing are a pervasive part of the development process. These can be functional or dysfunctional, as discussed, for example, in Khan (2000). The thesis of the proposed research is that both institutional resolutions and their consequences depend on the nature of the political settlement, the phase of development, sectoral characteristics and the particular mechanisms of rent-creation and sharing.

To explore this, it is useful to distinguish three broad dimensions of state-business relations that are relevant to economic dynamics and political functioning.

- First: the extent to which the political settlement and associated institutional structures provide credible commitments to businesses that the fruits of investment will not be expropriated.
- Second: the extent to which these institutional structures provide the incentives and support for business to undertake innovation, adapt to change, and engage in productive transitions, as the domestic economy and external environment evolves.
- Third: the extent to which the institutional structures involve political processes with respect to citizens that (a) support political and social stability (especially via inclusionary provisioning of public goods) and (b) are conducive to political and social demands for accountability in government and business.

These are discussed in turn.

The **first** area is necessary in all sectors and at all levels of development. It is intrinsic to the investment process precisely because of irreversibilities in investment: lumpy initial outlays in capital are required, with returns coming over time. For businesses to invest they need reasonable degrees of assurances that neither capital nor returns will be expropriated (e.g. via large changes in taxation or regulation), that the economic environment will not suffer major adverse shocks (e.g. of macroeconomic crises), that necessary complementary investments will be forthcoming (e.g. of roads and ports, and, over the longer-term, of skilled labour) and that there is sufficient political stability to underpin a growing market. All investments involve risk, but the extent of risk affects the required *ex ante* return for investment to occur, with higher risks leading to shorter-term and higher return needs, lower levels of aggregate business investment and potentially higher incentives for shorter-term rent extraction.

An initial condition for the existence of such commitment is a functioning state. Then, as Haber et al (2003) argue, building on the case of Mexico, a state that has the capacity to provide protection for investment also has the capacity to expropriate. In the absence of the ideal of “limited government”, that is of autonomous institutional structures that provide checks and balances

against opportunistic behaviour of state actors, a variety of alternative mechanisms can evolve. An important route is that of rent creation and rent-sharing, in which rents are shared between economic and political elites in a manner that makes it costly for state actors to renege on understandings. Such mechanisms can be provided by rent-sharing with third parties with a capacity to punish opportunistic behaviour, the intermingling of elites, and long-term and repeated interactions. These can be associated with particular groups of businesses, and, indeed, with particular politicians and political parties, leading to shifting business fortunes depending on who is in power (see below for literature on this.)²

Most developing countries will have a mixture of “informal” and formal mechanisms of resolving the credibility challenge. Informal deals can be illegal—as in outright corruption, or political finance in excess of rules—or legal, and can be part of long-term relations. In some cases, formal business associations play a significant role. The mechanisms will indeed be more effective the more long-term and the more institutionalized they are, in spite of their being informal. This can be constitutive of trust between state and business, in the sense of the consistency of behaviours within recognized norms.³

Informal mechanisms can co-exist with formal accountability structures that have some purchase on the system. This is to varying degrees a characteristic of all the cases. India illustrates: while widely considered to be thick with both long-term political-business relations and specific cases of corruption, the action of the office of the Comptroller and Auditor General (CAG) has played a high profile role in bringing alleged scams to public attention and legal action, notably over the allocation of 2G spectrum rights in 2008, alleged corruption in the 2010 Commonwealth Games, and allocations of blocks to produce coal over the 2004-09 period. Note, however, that such formal accountability structures can be in tension with informal mechanisms of credible commitment: if the system is based on informal deals and rent-sharing, the threat of a formal investigation can actually increase uncertainty around business investment. With respect to the other cases, South Africa probably is closer to a “rules-based” system, but informal political power and connectivity is arguably of rising importance, Egypt is closest to a system in which authoritarian power structures dominate countervailing accountability structures. Turkey probably falls in between—more authoritarian, and with a larger role for informal power, than India in the recent period, but with less perceived corruption (as reported by Transparency International, for instance).

A further alternative can involve external commitment mechanisms, such as commitments under the World Trade Organisation. Mexico’s joining of the North American Free Trade Association is a specific example of this, coming as it did after historic commitment mechanisms had been undercut by the expropriation of banks, severe macroeconomic instability and the presence of influential statist elements (Esquivel and Tornell, 1995). For Turkey, the Customs Union with the European Union in 1996 and the recognition of the country as a candidate for full membership in

² The debate in India as to whether the “reforms” of the 1980s and 1990s were essentially “pro-business” or “pro-market” is relevant here and illustrative. One important line of interpretation is that the decisive shift was toward a credible political and state commitment to support the business sector. See Kohli (2006a, b) and discussion below.

³ Credibility and trust are closely connected: Schneider and Maxfield (1997) suggest that “Credible is an adjective applied to particular policies; trust characterizes a more enduring and multifaceted relationship” (p.12)

1999 resulted in the adoption a whole set of laws and regulations (e.g. competition law, regulations for financial markets and network industries, rules regarding budget transparency) that aim to ensure a competitive environment and a level playing field. This has been referred to as the “EU anchor”.

Let’s turn now to the **second** category of institutional structure, that is concerned with innovation, adaptation and productive transitions? Here we have three inter-related theses.

First, the role of innovation and adaptation is less important in some phases and sectors. This is in particular the case for the production of natural resources from minerals, in the early “easy” phase of import substitution and in periods of growth in which construction activity is central. Substantial investment and growth can occur in these phases in spite of significant inefficiencies and rent-extraction. By contrast, when an economy moves into the more complex phase of industrial upgrading and service growth, and especially with open markets, innovation and adaptation is fundamental to what is essentially a project of economic transformation. Rents are also a major driver here, but now in the form of the “quasi-rents” gained from moving into new activities and reaping the initial benefits from such innovation (sometimes termed Schumpeterian and learning rents).

Second, “creative-destruction” is a central driver of innovation and adaptation. What matters here is the birth and death of new products and processes. This may occur through entry and exit of firms, or through changes within established firms, when external and internal incentives provide the incentives for such innovation. There are different views on the key drivers, and this will be directly relevant to the research. One view is that entry is an important driver of innovation, both through the direct introduction of new activities and through the competitive pressures on incumbents (Aghion and Howitt, 2006). This is broadly linked to the perspective of Acemoglu and Robinson (2012) that “inclusive” economic institutions are prerequisites for innovation-driven growth. Another view is that incumbent, diversified conglomerates (such as the business houses in India, or Turkey’s major conglomerates), will have both an encompassing perspective on growth opportunities, and be particularly well placed to channel financial and managerial resources into emerging new activities (see Khanna and Yafeh, 2007, for a review of alternative perspectives on conglomerates).

Third, the implications for the relations between state and business are quite different in the phase in which innovation and adaptation is central. This enters an important area of controversy in economics and policy design, concerning the role of the state in industrial (and modern service) development. A major tradition argues that the role of the state should be confined to the promotion of well-functioning, competitive markets and associated, market-supporting institutions (open international markets, legal underpinnings of stock markets, protection for minority shareholders, competition authorities, financial regulations, complementary infrastructure etc.) This perspective views the reduction of opportunities for rent-seeking as a central goal of economic policy design (see Krueger, 1974, for a classic exposition, and Khan, 2000 for a different perspective). Another tradition argues that a more sophisticated industrial strategy is beneficial, and may be necessary for the transition to innovation-based growth, to provide sector-specific public goods, incentives for innovation, and transitional support because of the

increased risk and externalities associated with innovation (see Hausmann and Rodrik, 2003, Rodrik, 2008, Evans, 1995). While this involves a more active state, a major focus within this tradition concerns how support can be provided whilst also assuring market or non-market disciplines, in order to provide incentives for creative-destruction and limit unproductive rent-seeking.

The proposed research doesn't take a general position on these controversies. It rather starts from the perspective that state-business interactions are already pervasive in developing countries (and indeed in developed countries), and that the interesting questions concern understanding how they function and what are their consequences (see also Schneider and Maxfield, 1997, on this point of departure). Here the nature of the resolution of issues of credibility and incentives for innovation and adaptation is the main focus, with the central research and policy concern being the tension between resolutions that favour unproductive rent-extraction as opposed to industrial and service upgrading and transformation (including through Schumpeterian and learning rents).

Issues of credibility and trust can have an important influence on the management of innovation—whether in terms of credibility that the state will allow destruction to occur, that the rule of law will be maintained, as well as commitments to provide sector-specific support in infrastructure or regulation. Information on needs and performance are also important—whether this is solved through decentralized market mechanisms, or effective information exchange between state and business actors.

The **third** general area concerns how far the political settlement and associated institutional structures (a) involves inclusive provisioning of public goods to the broader populace, and thereby sustains social and political stability, and (b) fosters demands for accountability in government and business.

There are several things to be explored here. These issues have instrumental consequences, in terms of the impact on business-state relations (and so on economic dynamics) and also have intrinsic consequences for middle and poorer groups. For (a), the instrumental question is whether the broader political processes lead to sufficient support for the political resolution with business. Social instability and political challenges to actual or perceived adverse redistributions, favoritism or corruption, can destabilize the arrangement with business within the political settlement. This can be bad or good for business and economic dynamics. It is bad if it leads to undermining of the credibility necessary for investment, or excessive hold-up over licenses, land acquisition etc. It can also be good, at least over the long term, if it leads to effective challenges to collusive rent-sharing, restrictions on competition, corrupt abuse of environmental and social conditions and so on, as in the Progressive movement in the United States.

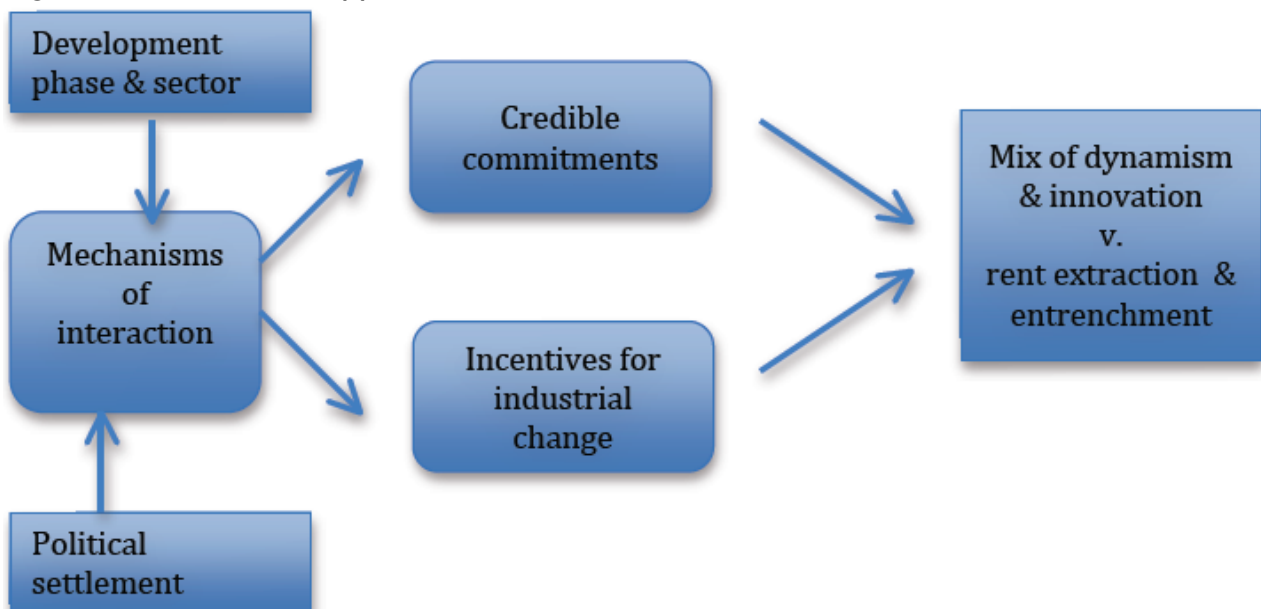
The last point is the idea behind (b), that concerns the circumstances in which there are effective societal demands for greater accountability in business-state interactions. One hypothesis is that demand for developmentally oriented accountability will rarely come from within the established business sector, but will potentially come from movements and associated political pressures from other societal groups (perhaps especially from “middle class” groups). Another hypothesis is that there may be circumstances in which parts of business are willing to accept more accountability as

part of formal mechanisms that generate more credible commitment. For example, TUSIAD (the association of traditional big business in Turkey) has been pro-EU for a long time, and it seems that they have been willing to endure the costs of a higher degree of accountability and transparency that would be associated with a more rule-based system. Alternatively business groups who are on the losing end of the status quo may support the transition to a more rules-based system, and so a more level playing field, e.g. the more “secular” businesses who are not closely associated with AKP under the current situation in Turkey.

The *intrinsic* issues of concern in this area relate to how far the political settlement supports political strategies that are aligned with the provision of public goods to all citizens, or at least to broad groups of, citizens, as opposed to entrenched, rent-extracting political processes. One point of departure is between ideal types of political resolutions, say, between predatory, clientelistic and programmatic processes. However, this is likely to be too restrictive, since a lot of the action will be within and between countries that are either broadly “personalized competitive” or “dominant party” but with significantly deals-based processes (see Levy, 2014 for further discussion of categories.) Then there is the more loosely defined domain of “populist” policies, that typically occur across regimes that bear similarities to each of these ideal types—including consolidated democracies in OECD countries. Many countries, and subnational domains within countries, that have been either personalized competitive or dominant party *also* have had good-enough track records in delivery of public goods. The question then is to understand the politics of support for this pattern.

A schematic presentation of the overall diagnostic frame is given in Figure 1.

Figure 1 Schematic of approach to state business relations



Source: authors.

Within this scheme we anticipate different issues for state-business interactions under political settlements that involve dominant parties (including authoritarian rulers) and those that are competitive (typically “personalized clientelistic”). The extent to which interactions are informal or

“deal-based” as opposed to rule-bound will have a central influence.⁴ In a historical context, these features will also reflect the nature of the formation of understandings, or implicit pacts, between political and economic elites. Also relevant is whether there are deep divisions in society (e.g. secular versus religious) where the political settlement has involved repression of one side of that division. The influences on behavior in all of these areas can be thought of as flowing from the interests of different groups and their “cognitive maps” and associated narratives, of both elite groups and of middle and poorer groups.⁵

This schematic highlights the “dual heritage” for business conditions at a point in time: first in terms of the production structure and business capabilities; and second in terms of the nature of business-state relations. Both matter for the challenges faced by business and state actors to resolve the credibility, information and coordination issues—or rather, whether these will be resolved in the direction of high or low levels of business investment, and in productive transformation or unproductive rent-extraction.

Different phases can co-exist at the same time. South Korea famously pursued a strategy of pushing businesses into export markets whilst keeping the domestic market highly protected. This allowed the business sector to enjoy rents from domestic protection whilst also having strong incentives to innovate and upgrade (Evans, 1997, Shafer, 1997). More broadly, many middle-income developing countries, including India, South Africa, Ghana, Indonesia, Brazil, Mexico, Peru, have *both* natural resource rents (mineral, spectrum etc.) *and* are interested in industrial and service upgrading. These may lead to different forms of state-business relations across sectors.⁶ More broadly, newer rents can emerge in the wake of growth processes. As Evans (1997) argues, success in one phase of economic transformation can lead to new challenges, here of the emergence of new sectors and activities with large opportunities for rent-extraction, in large part created by the success of the preceding phase of economic transformation. One important area concerns the increasing use of public-private partnerships in infrastructure, often considered a necessity in light of the major infrastructure bottlenecks (and relevant at least to India and Turkey in our cases).

The question in these areas is whether “collusive rent-extraction” in one domain or sector can distort both business decisions and state functioning in another, either through channeling private effort into this type of rent-extraction, or through undercutting the state’s capacity to provide the core functions for market-supporting institutions and the complementary inputs for potentially dynamic, innovation intensive sectors.

⁴ See Levy, 2014, for this mapping, that draws on a longer tradition including especially North, Wallis and Weingast (2009) and Khan (2011). The broader theme of “rules versus deals” is developed in Hallward-Driemeier, Khun-Jush, and Pritchett, 2010.

⁵ See Mehta and Walton (2014) for discussion of cognitive maps in an Indian context.

⁶ Examples from India are the states of Andhra Pradesh and Karnataka. Both became famous during booms associated with business-process outsourcing and information technology. These seem to have had the character of state-supporting industrial strategy in the key cities of Bangalore and Hyderabad (though this is a research issue!). But Karnataka more recently became infamous for the role of a mining business family in political finance, entering politics and illegally obtaining mining permissions. Structured rent-sharing is also central to the political economy of Andhra Pradesh (Natarajan and Walton, 2013).

India is again illustrative. There is a strong case that issues of credibility and trust were resolved by the 1980s, and that this interacted with a sufficient basis in business capability and production structures to support high levels of corporate investment (see for discussion of alternative views Kohli 2006a,b, Rodrik and Subramanian, 2004, Panagariya, 2008, Mehta and Walton, 2014). There is also evidence of significant efficiency gains during this period (see e.g. Topalova and Khandelwal, 2011) and of corporate profit behavior that is more typical of a competitive market than a highly entrenched one (Mody, Nath and Walton, 2011). However, since around 2010 the major concerns over business conditions have been over faltering private investment and public revelations of major scams (including by the CAG, as noted above). It is as if India has two faces of capitalism, and it is unclear which will be dominant. Interpreting the nature of state-business relations is not only of historical interest, but also central to assessment of options for future growth.

Literatures

The approach is linked to several literatures. While it is beyond the scope of this note to review these literatures, a few of the main links are sketched here. This includes in particular:

- The broad political economy of state business relations in the development process. This includes Haber et al (2003), Khan (2011) in the international literature. Two key insights are particularly relevant: that credible commitment is fundamental and unlikely to be guaranteed by “limited government”; and that there is a question of balance—rents can be functional, but can be destructive. A somewhat different and important political economy perspective is from Acemoglu and Robinson (2012), with the key link the idea that “inclusive”, as opposed to “extractive”, economic institutions are central to long-run growth (especially that phase of growth for which innovation and adaption is central), that this requires creative-destruction, and these are fundamentally shaped by “inclusive” as opposed to “extractive” political institutions. They also, however, argue that extended growth phases can occur under extractive institutions, where this is supported by specific political alignments. One way of viewing the positioning of our proposed research is as a further exploration of these issues, with a particular focus on the specific mechanisms that link political and economic processes.
- The tradition on the costs of rent-seeking activities, especially as it affects incentives for effort and the orientation of investment in an economy (for which Krueger, 1974, is the classic reference) or the design of regulation as a source of rents (see, for example, Djankov et al, 2002)
- Analysis of specific forms of state-business relations, especially where these are functional: for example, Evans (1995), Wade (1990), and papers in Maxfield and Schneider (1997). Key insights are of the role of credibility, trust and information; on the reciprocal character of relations; of the role of state capabilities and how the polity and different parts of the bureaucracy can have a degree of autonomy and impose budget constraints on businesses; and of the role of formal and informal mechanisms for resolution of collective action problems (e.g. business associations and networks). The question of the different ways in which corruption is linked to economic performance is discussed in Rock and Bonnett (2004). Also more suggestive, but relevant, are results of the potential for discipline in a personalized competitive context (Doner and Ramsay, 1997, on Thailand), or the potentially encompassing role of conglomerates, and of distinct sector-specific resolutions in the same country (Biddle and Milor, 1997 on Turkey).

- The effects on business performance of political connectedness. This includes the seminal paper by Fisman (2001) on Indonesia, Khwaja and Mian (2005) on Pakistan), Faccio (2006) on cross-country results, and recent work by Chekir and Diwan (2012) on Egypt and Novodad and Asher (2012) on India. One common technique is exploration of effects on stock market valuations, in response to unanticipated political shocks. This category of work also explores mechanisms of favoured treatment, through access to lending, bailouts, market shares, regulatory preferences.
- More broadly the literature on the “business-friendliness” of the policy environment and its impact on business growth is relevant to the research. See on India Aghion et al (2008), Besley and Burgess (2004) and Calí and Sen (2011), in addition to the works cited earlier. Also relevant are the World Bank enterprise surveys (that will be used in this proposal) and associated analysis of the investment climate, and the “doing business” surveys. While these are about proximate context rather than underlying drivers, they provide information on the pattern and extent of business interactions with government actors.
- The relationship between business structure and the forms of capitalism: see Morck et al (2005), Khanna and Palepu (2002) on the role of large business families, with a set of advantages in solving market failures but also potential for economic retrenchment, expropriation of minority shareholders and excessive influence over markets and state. Guerrero, López Calva and Walton (2009) explore this for the case of Mexico. This relates more broadly to the “varieties of capitalism” literature, both with respect to nature of the business sector itself (e.g. Hall and Soskice, 2001) and to the relationship with alternative approaches to social provisioning for the broader society (e.g. Esping-Andersen, 1990).
- Economics of innovation under imperfect competition, especially “Schumpeterian growth theory” and the role of entry on innovation and business dynamics (Aghion and Hewitt, 2006, and the perspective of Parente and Prescott, 2002 that is more concerned with restrictions to competition).

The research approach cuts across these literatures, with the closest linkages to overall political economy and the different types of firm-level analysis. We see bringing these approaches together as being a valuable contribution, and through this contributing to broader interpretation of the nature and varieties of capitalism in middle income countries in a globally connected world.

Goal

The goal of the research is to understand the nature and consequences of business-state interactions, through exploration of the politics of these relations, and documentation of the variety of mechanisms in which this plays out. This will be used to assess the welfare consequences for both the economic drivers of business dynamics and further influences on political functioning and state behavior. This will include analysis of the consequences for the rate and pattern of business investment, productivity growth and links to the employment growth, environment, and social conditions. It will be based on a mix of analysis of politician-business relations—and how these fit within the overall political settlement—firm-level econometric analysis and sectoral case studies. It will then draw pragmatic implications for public policy.

The big challenge is to understand trajectories—especially on the apparent knife-edge between mutually productive relations and collusive rent-sharing. We argue that there is a need for both an explicit political account, and careful documentation of formal and informal mechanisms, including the origins and behavior of formal legal and policy “choices.”

3. Significance of study:

We see the study as being centrally related to the overall ESID goal of understanding the political dimensions of inclusive development, and in particular the ways in which elite interactions—between political and economic elites—shape the level and pattern of economic dynamism, the extent to which this is sustainable, and the extent to which this leads to broad participation in the process of development. Two areas of innovation are:

- Explicit analysis of the relationship between the political settlement and state-business relations, with a particular focus on actual mechanisms and networks. This will also include exploration of how narratives (ideological, cognitive maps on policy options and political strategies), relates to a more interest-based political economy of policy design.
- The linking of this political assessment to firm-level behavior, using both econometric and case study methods, both as a bridge between political analysis and domains of analysis of productivity and growth, and to inform broader discussions on the nature of, and variation in, capitalism in middle income countries.

In terms of the demand for the research, we see great interest in understanding how state business relations influence the development process, as reflected in widespread public debate on this question, whether this focuses on sustaining growth or expressed concerns over “cronyism” and corruption, business influence over politics, and links to inclusion and inequality. This applies to the countries of the research project and also much more broadly. In addition to broad public debate, there is a more focused concern from (some) policymakers about what can be done in the typically complex conditions of their countries.

4. ESID core research questions to be addressed:

The overarching research questions of ESID are:

(1) What capacities enable states to help deliver inclusive development?

(2) What shapes elite commitment to delivering inclusive development and state effectiveness?

(3) Under what conditions do developmental forms of state capacity and elite commitment emerge and become sustained? In particular, what role do power relations and ideas play here?

The proposed research is directly related to ESID’s questions (2) and (3). We would particularly emphasize the explicit analysis of elite relations within the overall political settlement, and the ways in which this is supported or challenged by the broader aspects of state-societal relations, including the relationship with overall public good provision and societal coalitions for greater accountability and rules-based business-state relations. Issues of state capacity are not a direct

focus of the study, though there will be analysis of the effectiveness of state policies on business performance.

5. Project research question(s):

Here are initial hypotheses.

(1a) Even in “liberalized” economic regimes, with modest trade protection, there are substantial domains of rent creation and sharing. These are intrinsic features of the political settlement. They are typically underpinned by personal and political networks, that are often linked to political party finance. They can be “functional” both to the workings of the political settlement, and to providing the credible commitment for private investment, at least for insiders. The ways in which they function will depend on the extent to which the polity is democratic or authoritarian, and dominant party of competitive—with deeper and more extensive pathologies in less politically competitive regimes. However, these processes are typically also present in “personalized competitive” democracies (and in consolidated democracies).

This we expect to document in all the Indian states, for Turkey, in a more extreme form in Egypt, and in the post-apartheid settlement in South Africa.

(1b) However, in some circumstances, protected, rent-sharing processes can allow the building of industrial and commercial capabilities. This is exemplified by many parts of India’s industry, including the iconic IT sector (see Sharma, 2009). It is also illustrated by Turkey’s industrial development, where import substitution industrialization in the 1970s led to the creation of many inefficient industries but also laid the base on which the export-oriented automotive industry was built. Similarly, export subsidies of the 1980s involved substantial corruption but had a positive effect on the evolution of Turkey’s export orientation from an almost completely closed and protected economy. The research (and policy) challenge is to document and explore when rent-sharing processes are also aligned with building these capabilities, and when they foster economic and political entrenchment.

(2) Given the tendency for exclusionary and unequal outcomes of rent-sharing arrangements, there is tension with the politics of middle and poorer groups, especially in electoral democracies, but also in authoritarian regimes. This can be politically managed by a variety of specific political strategies, interacting with the pattern of economic developments. These include:

- Repression, notably in Egypt and pre-democracy South Africa
- Various mixes of populist, clientelistic and public good providing strategies, that can range from the common “populist trap”, to “good populism”, that merges into effective public good provision (Tamil Nadu seems to be an example of such a blend), and transitions to encompassing public good provision, based on programmatic political competition.
- Emergence of broader, politically salient, business classes, for example the “Anatolian tigers” in Turkey.
- New forms of rent-sharing, with inclusion of emergent economic elites from previously disadvantaged groups, as with business entry from non-“business” castes in India, and black empowerment in South Africa.

- Each of these will be explored in relation to the prevailing ideological narratives of inclusion, that are features, in varying forms, of all the countries and states being analysed.

(3a) A cronyist trap? While rent-sharing arrangements can underpin investment and political stability, and can also support phases of growth, they tend to undercut longer-term dynamics through entry restrictions, inefficient allocations and distortions, especially through the mutually attractive gains for political and economic elites of collusion (whether illegal or formally underwritten by legal process).

(3b) A dynamic alternative? Alternatively there can be circumstances in which industrial and service sector interests lead to long-run productivity dynamics. This may flow from global competition, but will also depend on the cognitive maps and aspirations of political and business elites. Two processes will be explored.

- First, major businesses may strategically evolve from being primarily based in rent-extracting domains and processes to being globally competitive, driven by corporate ambition, crises inducing changes in economic policy, or long-term government industrial strategy. (This is a feature, for example, of the strategy of many of Mexico's major conglomerates.)
- Second, there can be sectoral islands of dynamism, driven by domestic or international competition, or other sources of pressure and disciplining.
- Third, "multi-class alliances" may be an important platform for sustaining dynamism. This could involve a strengthening middle class, social movements to combat corruption, or perhaps an alliance around better public service provision.

In all areas, the research interest is on the interaction between the specific trajectory, local political economy (around the sector or firm) and the overall system functioning—including, in particular, adverse interactions between rent-extracting sectors and dynamic sectors.

6. Methods and research design:

The structure of the research will involve parallel, country and Indian subnational state-level analyses within a common methodological frame. The comparative component will then be brought out through comparing specific areas and an overall synthesis. The following lists the areas of analysis, and Table 1, below, provides an initial characterization of the various cases. For each country, the broader context of the political settlement has, or is being, analyzed in separate work that falls outside this research project (see in particular, Mehta and Walton, 2014, Diwan et al, 2012, and the ongoing ESID-funded project by Brian Levy and Alan Hirsch).

Studies of mechanisms and networks

This would draw on the broader political settlement pieces, but would have greater specificity to support analysis of processes. We plan to explore, and search for documentation, of those networks involving mechanisms that are functional to the political settlement and, specifically, to both business and politician behaviour.

The approach would be to select domains/network areas based on an assessment of what is most salient (from the political settlement analysis and other analyses of state-business interactions). Domains and networks will thus be of the most important areas, and not fully comprehensive. It would aim to cover particularly important business and political families, and particular processes.

Illustrative examples of selection:

- The top 10 business and political families in the country or state of focus
- Families connected with the Mubarak family in Egypt
- Construction firms, or participants in private tertiary colleges in Andhra Pradesh

The research approach will generally involve moving between publicly available data sources and elite interviews—the latter as key informants on the nature of mechanisms and the structure of connectivity. Informants may be from within the business or political sectors, journalists, financial analysts and so on, sampling from a mixture of information on business size and ownership, major political families and snowball sampling. An in-depth example is being undertaken in the ESID-financed seed project on the role of networks and mechanisms in tertiary education in the state of Andhra Pradesh, by the India Institute (via the Centre for Policy Research). In this case, key informants of processes of rent-sharing in the state described a mechanism in which budgetary support for scholarships became a source of rents from private colleges, with licenses for colleges becoming linked to politicians. The research is carefully documenting both the actors and processes. In a second example, in ongoing work Ishac Diwan and co-authors has used data on large industries in Egypt, to identify politically connected firms, and used this for econometric analysis on the patterns of firm behavior—this bridges to the next activity.

Econometric analysis of firm- and sectoral performance

This part of the research would use existing firm-level data bases to develop an econometric analysis of performance of the business sector in relation to proxies for connectedness with the state. Two elements are planned.

(a) Development of a sectoral indicator of regulatory intensity. The World Bank's Enterprise Surveys, conducted in over 140 countries, provide firm-level data on interactions between firms and the state across the range of dimensions described above. In existing work, Paul Novosad and Sam Asher (2012) have begun building a series of sector-level indicators of government interaction intensity from these surveys. This would be extended to develop a database that would support analysis of the pattern of variation in government involvement across sectors and countries, analysis of the case studies in relation to the global variation, and provide an input into the firm level analysis, in the form of a proxy for rent-intensive sectors. While government involvement is traditionally proxied by firm ownership, this measure will cover other ways in which firms interact with public officials, including tax payments and audits, payment of bribes, application for required licenses and clearances, and the use of publicly provided electricity and road infrastructure.

These data are currently disaggregated across some 350 country surveys. While the World Bank releases a standardized cross-country dataset, it is oriented around cross-country comparisons and is missing detailed data on firm sectors, is not representative at the industry level, and omits data from informal firms, microenterprises and service sectors. The proposed work will use a methodology that orders industries according to facets of government input intensity using only *within-country* variation, to avoid bias from the existence or non-existence of certain types of industries in certain types of countries.

The outputs will consist of (i) a set of industry-level measures that describe how firms in particular industries interact with government actors, in terms of average patterns across countries; and (ii) a set of country-industry level measures which can be referenced to the mean industry measures. The first set of measures is expected to be of broad use to researchers. The second allows us to focus on a single country and identify specific sectors that are particularly dependent on government, an approach which is of direct relevance to the case studies in this proposal. An accompanying paper will describe the construction and use of the data.

(b) Analysis of firm performance. This would involve panel level analysis of firm dynamics in relation to firm and sectoral characteristics, policy environment, regulatory intensity and connectedness. It would [tentatively] include a core comparative analysis based on variables that are common across cases, with extended analyses depending on the availability and quality of data in the country-specific data bases. We are interested in understanding how measures of firm performance, including sales growth, profitability and productivity, relate to sector competitiveness (market share, concentration indices, tariffs), entry and exit, borrowing, regulatory intensity and any independent measures of connectedness. This would build on existing work on political connections and firm performance on Egypt by Chekir and Diwan (2012), on ongoing analysis of Turkish firms by Izak Atiyas, and analysis of the profitability of firms in India by Mody, Nath and Walton (2011). (The India analysis will probably have to be on an India-wide basis, since the Prowess data base is unlikely to support subnational state-level analysis of the kind planned).

In-depth sector cases

The sectoral case studies are micro-level complements to the economy-wide analyses of networks and mechanisms. Sector-level analysis has both advantages and limitations.

The limitation of sectoral studies as a way of understanding business-state relationships is that they offer a very partial view; they illuminate only a very partial (and likely very distinctive, and perhaps idiosyncratic) subset of the broader patterns of business-state relationships. To offset this limitation, the case studies will focus on sectors where business-state relationships are typically strong, and potentially decisive, in accounting for performance. To meet this criterion, and as a way of assuring comparability, the sectoral case studies in each geographic area will involve at least two of the following:

- The telecommunications sector (focusing especially on investments in fixed-line ‘backbone’ and on the rules of the game governing mobile telephony) – as a vibrant, growth sector,

where the regulatory regime plays a decisive role in shaping the terms of competition, and the opportunities for individual firms;

- The automotive sector – a common, high-profile target for industrial policy, where rules governing protection against imports (both of components and fully assembled vehicles), and export support play a powerful role in shaping both industrial structure and patterns of market penetration; and
- The construction sector – where a substantial fraction of business comes from large-scale contracting with the public sector, and where it is hypothesized that the productivity of the sector is shaped by the manner in which this procurement relationship is governed, the balance struck by individual firms between contracting with public versus private clients, (and perhaps also differential access to credit among firms).

All sectors are of particular interest: they are strategically important from a broader economic perspective, and are sectors where the opportunities are large for dynamic, productivity-oriented performance – but where the roles of rents (and associated consequences for performance) also are potentially large.

We provisionally will also incorporate in-depth research on coal and electricity, as this is the central focus of the doctoral research of Rohit Chandra, currently studying for a Harvard PhD. He already has in-depth knowledge of coal in India, and is building a comparative research program, that could include South Africa, and potentially Turkey. This would be funded separately.

The advantage of sector-level studies is that they provide an opportunity to focus research in ways which have the potential to illuminate very clearly the inter-relations between sectoral performance, policy and networks of ownership and political influence. At the sectoral level each of the following can be addressed more straightforwardly than at the economy-wide level:

- *Sector-level networks.* Research to map out sector-level networks will proceed in a similar way to the country-level work. But at the sectoral level, it is likely to be easier to get an overall characterization of the relationship: the focus can be on the relatively small number of dominant firms, their patterns of ownership, and the networks that link these patterns of ownership to the political and bureaucratic realms.
- *Sector-level performance and policy.* With a sector-level focus, it will be relatively straightforward for the research to characterize and measure the dependent variable (performance over time) – both for the sector as a whole, and for the leading firms within the sector. This will be supported by an economic analysis to identify the key public sector policy and other actions which affect performance. These actions will in turn be the target for in-depth analysis of how networks of influence play out in practice.

Process tracing mechanisms of influence. Following Levy and Walton (2013) the methodology we plan to adopt for this part of the sectoral studies will be that of an analytic narrative – organized around ‘process tracing’ of the evolution of how decisions were made (and relevant follow-up actions played out) vis-à-vis the key public actions which influenced sectoral performance.

Through such process tracing, generalized propositions as to the character of business-state relations can come vividly to life – and will hopefully offer important insights into channels of influence in decision-making and the reality of who in practice are the influential actors.

“Observational” analysis, from local media reports, secondary sources, interviews, and other qualitative techniques, can provide a basis for describing the relevant decision processes, which then can be important inputs to a conceptual interpretation of the behavior of the system of business-state relationships at the sectoral level.

Research on broader influences on state-business interactions.

An important part of the proposal involves embedding the state-business relations in the context of broader electoral, civil society and formal accountability influences. This will have been developed in general terms in the political settlement papers. We will design the specific follow up after results from the above areas are coming in, that would particularly look at sources of pressure for change (especially, but by no means exclusively in a positive direction, away from economic and political entrenchment to more open, “inclusive”, political and economic structures or processes). This could also use comparative experience from the literature e.g. from the classic shift under the US Progressive movement; or sector-specific changes, as with telecoms in Mexico. This we see as a central bridge to integrating the analysis of business-state relations and economic dynamism or entrenchment from above to a broader assessment of political functioning, political strategies, socio-political inclusion or exclusion and associated narratives.

Choice of cases

The interest in the cases selected is based on the following considerations.

First, the issues we are concerned with are of central concern to middle income countries (and richer). We are interested in interactions between functional states and reasonably developed corporate sectors. There are, of course, issues of interest on state-business interactions in low income countries, but these are of a different category e.g. the conditions under which take-off can occur with a small, personally interlocking political and economic elite; or on the management of interactions, especially in mining, when domestic or foreign corporations are large in size, and have much greater capabilities than a low income state. But this would genuinely extend the research project into new areas, and this could not be handled within the current scope of work.

Second, there is a question on how the cases fit within the variety of political settlements. Looking across all middle income countries, we see the bulk of the action—and especially so with respect to the future—to be in societies that have formal democracies (in terms of actual or potential alternation of power, and at least some degree of formal accountability via justice and regulatory institutions). However, there is a lot of variation in the extent to which polities have de facto dominant political coalitions, and the extent to which accountability institutions are influenced by either power or money. So we see it of most interest to have a set of cases that reflect this gradation, seeing the authoritarian dominant party as an extreme position within this continuum. We also wanted cases that had gone through trade opening and other liberalisations in the past 25 years (though that is most countries in the world now). Given this, the following is how we would

outline our range of cases, moving from the most to least politically competitive in the present conjuncture.

- i. India (plus subnational cases): established democracy, real alternation of parties at national and local level, accountability institutions with some independence, but high levels of business-state legal and illegal connectivity. The subnational cases we'll focus on will be on the relatively richer, industrializing states, that have a mixture of real productivity dynamics and tight connections between business and economic elites.
- ii. Turkey: democracy with alternation of power and some independence of judiciary, but an electorally dominant political party, that has been exerting increasing influence over accountability institutions. Has old established corporate sector with traditional political links and dynamic emergent new business sector.
- iii. South Africa: democracy with no alternation of power at national level since its democratic transition, but unusually autonomous accountability institutions. Old established corporate sector in white and foreign hands; Black Economic Empowerment a mechanism to create a new black elite, but with significant rent-sharing.
- iv. Egypt: semi-authoritarian to authoritarian, despite recent alternation of power, an extreme case in the sample, in terms of a dominant political elite and associated "cronies", but also has established firms outside this net.

The key features of the cases are summarized in Table 1 below.

Table 1 Key features of cases

	India/dynamic Indian states	South Africa	Turkey	Egypt
Polity	Established democracy; alternating parties	Democracy, extensive period of authoritarian rule; dominant party	Democracy, past periods of authoritarian rule, dominant party in recent period	Authoritarian with a very brief period of partial democracy
Business structure	Diversified, extensive conglomerates, huge small scale sector, limited medium scale	Large conglomerates, limited SME sector	Mix of established conglomerate and emerging medium sized sector	Limited number of conglomerates
Core state-business relation	Extensive business-politician relations; increasing overlap in roles	Political deal between conglomerates, new black business elite, dominant political party	Anatolian tigers a support base for ruling party; some ties with conglomerates	Subset of conglomerates with strong political connections
Rules v. deals; formal accountability	Hybrid: formal accountability processes matter, widespread deal-making, both individual and systemic	Strong rule-based tradition; informal deal-making may be on the rise	Hybrid, but substantial political power over state apparatus	Political power over state apparatus

7. Activities:

The research activities correspond to the areas of research listed above, plus country syntheses and a comparative synthesis.

8. Outputs:

As the above activities indicate, there is a significant range of potential outputs. Which of these support independent publication and which become inputs to either country or comparative syntheses will depend on the conceptual and empirical value of specific pieces. This is the current plan for working papers, from which we anticipate a range of publications would emerge. As we

get into the analysis, it may make sense to combine some of these into more aggregate working papers.

Mechanisms and networks. Four working papers, at the country level for Egypt, Turkey and South Africa, and a comparative analysis of three relatively economically advanced states of India (provisionally Andhra Pradesh, Tamil Nadu and either Gujarat or Karnataka.)

Regulatory index. One working paper describing methodology, properties and patterns in the cross-country data (this may end be broken into two papers.)

Econometric analysis. A minimum of two working papers: one comparing patterns across Egypt, Turkey and (provisionally) South Africa; and one on India. This may end as self-standing country papers, but we commit to two, since this will depend on analysis of the data quality, and indeed on results.

Sectoral studies. We are planning analysis of 2-3 sectors in each of the four countries. There will be working material for all of these. What we have not yet determined is the best design of any working papers: this may be more interesting structured as inter-sectoral comparison within country; alternatively as cross-country comparison for the same sector. For this reason we commit to at least one working paper, but with the expectation that it will be fruitful to structure this into more papers.

Broader influences and country syntheses. Since this part will have a considerable country-specific material on politics, narratives and social structure, we plan to have one working paper for each country, that will also serve as a synthesis of the earlier results on business-state relations, findings on dynamism (or its lack), and sectoral insights.

Overall synthesis. We plan to approach the overall synthesis in two phases. Early in the project—later in 2014—we would have an initial meeting of a small group core authors, to deepen the conceptualisation of the approach, based on early work. This is likely to produce a preliminary assessment, and could influence the ongoing empirical work. Then a formal written product would be developed at the end of the project, that would be a more ambitious treatment of both the overall results and what these imply for bigger questions around the politics of business, state and society and the nature of capitalism in emerging market economies.

We currently plan for the working papers to come out over the course of 2015 and early 2016, with more formal publications following.

9. Plans for dissemination, communication and uptake:

There will be a range of products to support engagement with a variety of communities. These include:

- Research products, including working papers (to be brought out as ESID working papers, and also as working papers in the various organisations, including of the Harvard Kennedy School, the Economic Research Forum, the Centre for Policy Research, the University of Cape Town), plus publications in journals for a subset of these.

- Accessible country and comparative syntheses written for a broader audience, in the research countries and for the international development community
- Opens on specific issues, especially in the research countries.
- Use of cases and techniques in teaching, as the core researchers are all involved in graduate teaching programs in economic development

10. Capacity strengthening implications

All the research will involve work with institutions in the countries of focus, and, for Egypt and Turkey the relevant regional organisations. This includes, but is not limited to the Economic Research Forum, that brings together researchers on the Arab countries and Turkey (Atiyas and Diwan active members), the Centre for Policy Research, New Delhi (Walton), and the University of Cape Town, South Africa (Levy). Some younger researchers will be brought on once the detailed research design is finalized.

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12. Researchers:

The core work will be undertaken by country-focused teams. The main researchers for each country are as follows. We anticipate adding some junior researchers or collaborators on specific tasks. Coordination will be undertaken as a collective effort by Atiyas, Diwan, Levy and Walton (Walton can be the primary point of contact for administrative purposes); comparative syntheses will be undertaken by various configurations of authors, depending on how the research unfolds, and will be guaranteed by this core group.

Egypt and Turkey

Ishac Diwan, Kennedy School of Government, Harvard University

Izak Atiyas, Sabancı University and TUSIAD-Sabancı University Competitiveness Forum

Additional authors to be determined, especially for Egypt.

India

Michael Walton, Kennedy School of Government, Harvard University and Centre for Policy Research, New Delhi.

Pallavi Roy, School of Oriental and Asian Studies

Ashoka Mody, Princeton University

Yamini Aiyar, Centre for Policy Research, Devesh Kapur, Centre for the Advanced Study of India, University of Pennsylvania, and Gulzar Natarajan, Indian Administrative Service, will also be involved in advising, and potentially other engagement in the research.

South Africa

Brian Levy, Johns Hopkins University, and University of Cape Town

Alan Hirsch, University of Cape Town

Deborah Posel, University of Cape Town

Anthony Black, University of Cape Town

Mike Morris, University of Cape Town

Regulatory index

Paul Novosad, Dartmouth College

Sam Asher, Oxford University

Additional comparative work on coal and power (outside project budget)

Rohit Chandra, Harvard University