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COSTS AND BENEFITS OF BUSINESS-GOVERNMENT RELATIONS: EMPIRICAL ANALYSIS OF FORMER-COMMUNIST TRANSITION ECONOMIES

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ABSTRACT

This paper examines the costs and benefits of business-government relations in firm behaviors in the empirical context of 25 former-communist transition economies. We find that the firms contributing high taxes and employment are more capable of influencing government policies related to their businesses. While a firm's competence in influencing government policies in turn decreases bribery to government officials and increases the successful securing of government contracts, the same competence increases a firm's structural inertia of maintaining existing courses of action by discouraging the firm from starting new production lines and discontinuing obsolete production lines.

Keywords: Business-Government Relations; Government Policy; Structural Inertia; Transition Economies.

1. INTRODUCTION

It has been widely accepted that firms receive economic benefits through building and maintaining a good relationship with their governments (Bertrand, Kramarz, Schoar, & Thesmar, 2004; Faccio, 2006; Johnson & Mitton, 2003; Li, Meng, Wang, & Zhou, 2008). Previous research suggests that business-government relations help firms in various ways: the securing of favorable regulatory conditions (Agrawal & Knoeber, 2001) and access to resources, such as bank loans (Faccio, 2006; Khwaja & Mian, 2005). While business-government relations are a form of exchange, previous studies mostly focus on the benefit side of firms and few studies examine the costs that firms need to pay for such exchange and the consequence of paying such costs in the long run. Business strategy research often stress their benefit side by asking what benefits firms can extract from them, and through what mechanisms these benefits can be obtained (Hillman, Keim, & Schuler, 2004). When it comes to the cost of building government relations, however, strategy research tends to narrowly focus on activities that are easily visible and directly pointing to political connection building, such as social activities (drinking and dining) and bribery activities. However, such visible activities are only a small part of the business-government exchange. The bigger picture can be related to macros aspects of economic development and corporate activities. For instance, incumbent politicians, not only seeking for briberies, may want to see business corporations contribute to economic development and job creation. Such contribution to economic stability helps politicians to gain popular support from the society, increase their legitimacy, and thus extend their tenure. While it is true that firms typically attempt to reduce any redundant employment and use strategic accounting to minimize taxation, firms can get access to stronger

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relationships with incumbent politicians (and bureaucrats) by helping to reduce unemployment rates and increase government income through paying more taxes. In doing so, firms can become more powerful in influencing changes to laws and regulations that may have an important impact on their businesses.

In this study, we investigate the costs and benefits of building business-government relations with incumbent politicians and bureaucrats, and then analyze whether and how business-government relations influence firms' decisions on subsequent corporate development in the context of transition economies. The business-government relationship is important in transition economies because these countries undergo a series of changes, and their governments target economic growth, thus providing more opportunities for firms and government officials to engage in exchange behavior. Moreover, as transition economies have become increasingly important in the global economy, we need to understand how the business-government relationship functions in these fast growing economies and understand how such relationships influence firms' behavior and development in the long run.

Linking discussions on business-government relations from a business strategy perspective and political science perspective, this paper reveals the cost as well as potential benefits that business-government relations can offer to firms. Understanding whether and how business-government relations impact firm behavior and its subsequent development can generate better knowledge of the long-term effect of such relations and lead to the discussion of whether and when business-government relations are worth building. Thus, this paper presents the costs and benefits of developing business-government relations and analyzes the consequence of business-government relations on firms' further development in the context of transition economies. In the following, we provide a literature review on transition economies and business-government relations and develop several testable hypotheses on the topic of interest. Then, we present the methodology of the study and report the results of empirical analysis and discuss the findings, limitations and future research direction.

2. EMPIRICAL CONTEXT: TRANSITION ECONOMIES

A transition economy is one that is transforming from a centrally planned economy to a market economy. While researchers studying transition economies focus on countries in Central and Eastern Europe and the Former Soviet Union, the term "transition economies" indeed has a broader meaning. Countries that are outside Europe and transforming from a socialist-type command economy to a market-based economy, for example, China, are also members of transition economies.

Based on Fischer and Gelb (1991), the IMF (2000) summarizes the following as components of the transition process: liberalization, macroeconomic stabilization, restructuring and privatization, and legal and institutional reforms. Liberalization refers to the transformation from controlled markets to free markets. This process includes allowing markets to determine most of the prices and lowering trade barriers that would inhibit contact with the price structure of the world's market economies. Market liberalization opens up originally sealed markets and encourages investment from both domestic and world markets. The sudden increase in investment creates an inflation surge (Ghosh, 1997); thus, governments must be disciplined with budgets as well as fiscal and monetary policies to contain the inflation rate, and this process is macroeconomic stabilization (Debrun and Kapoor, 2010). Restructuring and privatization refer to the processes of establishing feasible financial institutions and reforming the enterprises in these economies such that the ownership of these enterprises can be transferred into private hands. Finally, these countries need to undergo legal and institutional reforms to

redefine the role of the state in the economy, formulate laws and regulations, and introduce appropriate competition policies to achieve natural market efficiency.

In his paper based on the case of China, one of the large transition economies, Liou (1998) summarizes five major roles of government in the process of economic development: protector of citizen, distributor of income, manager of economy and business, regulator of industry, and promoter of growth. As protectors, governments need public policies to protect citizens and businesses from hostile social unrest, hostile international relations and illegitimate political appropriation. Only by doing so, can governments provide a peaceful and stable domestic environment for businesses to operate in and for the economy to grow. As distributors, governments must balance class and regional income inequality and redistribute through formulating and implementing social welfare policies and initiating development projects in rural areas where its residents usually have relatively low incomes compared to people living in urban areas. A stable economic environment is a crucial factor for economic growth. To assure a safe and stable economic environment, governments need to adjust monetary policy and fiscal policy to minimize both the unemployment rate and the inflation rate, as a high unemployment rate creates a burden for social welfare systems, and a high inflation rate deters investment. In economic transition countries, private property rights are usually not protected. During the process of transition, governments begin to formulate and test rules and regulations to create an environment in which business can operate and individuals' rights are sufficiently protected. The final role of governments in transition economies is to act as promoters of economic growth and social development. To promote economic growth, governments must implement public policies to invest in public infrastructure and to promote the development of business sectors in both domestic and international markets.

Because economic development is seen as one of the important benchmarks to evaluate the achievement of a government, an incumbent government, particularly one that targets economic transformation and rapid growth, would therefore attempt to fulfill the roles proposed by Liou (1998). Tenure and promotion of policy-making government officials and politicians are highly associated with economic growth. In countries with voting systems, it is obvious to expect citizens to favor the incumbent government when the economy is booming, and this explains why government officials care about the economic environment. Unexpectedly, for countries without voting systems, even countries with only one political party, such as China, the story is more or less the same. In China, for example, the central government formulates national economic growth targets every year and distributes the target down to the provincial level and so on. Therefore, each province, each town and each regional industry has its own yearly target. At the end of each year, provincial, township and regional industrial leaders' achievements are evaluated against the targets. Approximately, every five years, the central government evaluates these leaders' overall performance and decides whether they should stay, get promoted or be kicked out. Guo's (2009) study finds evidence that Chinese regional leaders do respond to the performance evaluation by stimulating economic growth through increasing public expenditure.

Mr. Vito Tanzi, Director of the IMF's Fiscal Affairs Department, commented that "*the transformation to a market economy is not complete until functioning fiscal institutions and reasonable and affordable expenditure programs, including basic social safety nets for the unemployed, the sick, and the elderly, are in place. Spending programs must be financed from public revenues generated—through taxation—without imposing excessive burdens on the private sector"* (Tanzi, 1999). Thus, the level of tax revenue is another indicator of government officials' performance. To achieve outstanding performance in growth and successfully transform the economy, governments need firms to hire, invest and pay taxes. As firms continue to hire and invest, the unemployment rate declines and government income, i.e., tax revenue, increases, and, in turn, regional leaders' appraisal scores improve, enhancing the chances of their tenure extension and promotion.

When transforming from socialist economies to market economies, countries experience a long process of experimentation to see how the market works best and how to stimulate the economy to grow faster. During such processes, there are a series of regulations and deregulations, and governments formulate various sets of policies to boost the economy. Thus, this process provides a good opportunity for firms to influence their governments to formulate regulations and policies that are favorable for their businesses to operate in.

3. HYPOTHESES

In advancing the study of business-government relations at the firm level, we ask the following three research questions: 1) what does it take for firms to build relationships with governments, in particular incumbent politicians and top-level, policy-making bureaucrats? 2) What benefits can firms get besides being able to influence regulations and policies that concern them? Additionally, 3) what are the consequences in the long run; in particular, whether and how business-government relations influence firm behavior and development? In this section we develop hypotheses by addressing these three questions.

3.1. Building Relationships with Policy-Making Politicians

Many business strategy scholars use resource dependence theory (Pfeffer & Salancik, 2003) to explain the business-government relationship and discuss various ways used by firms to manage this relationship. According to this perspective, all organizations, including business firms situated in an open system, are dependent on external resources for survival and growth. Government is definitely one of the most important sources of external resources in transition economies. Due to the "institutional voids" prevailing in the transition economies, which are characterized by the absence of well-developed regulatory systems and the dearth of well-functioning contract-enforcing mechanisms and intermediaries in product, labor and capital markets (Khanna, Palepu, & Sinha, 2005), government agencies control more resources and discretionary power and create more uncertainties for business activities than their developed economy counterparts. When the institutional environment is less predictable, business-government relations help firms cope with policy changes and even allow firms to influence such changes to favor their operations (Agrawal & Knoeber, 2001). Therefore, business-government relations, or political connections, are very important in transition markets. Scholars studying business-government relations from the business perspective always emphasize what firms can extract from such relationships while paying less attention to what firms must pay in return; however, firms do not receive benefits from the government without paying anything back (Frye, 2002). Even if some scholars try to delineate the costs of building government relations, the topics are primarily limited to visible ones, such as bribery and entertainment expenses.

Although resource dependence theory (Pfeffer & Salancik, 2003) highlights a mutual dependency relationship, most business strategy scholars take it as a one-way relationship by only examining what firms can get from the government but ignoring what resources governments depend on that can be provided by business entities. From evidence around the world, it is clear that business-government relations are a form of "exchange" between firms and politicians. In such exchanges, economic rewards are transferred to firms, and then, firms offer politicians politically valuable services in return. One thing that the government or incumbent politicians want and the business sector can give is economic stability (Quinn & Woolley, 2001). Economic stability is crucial to a government because it is highly related to the tenure of incumbent politicians who are currently running the government. For instance, the Pro-Russian party, a political party that is believed to be unpopular in Latvia, a country that is trying

to distance itself from its communist past, subsequent to its independence from Russia, wins Latvian elections because the previous government was not successful when it faced a financial crisis (Buehrer, 2011). Bertrand et al. (2004) find that business leaders from politically connected firms in France create more jobs to build "re-election favors" for incumbent politicians.

Other than that, politicians also expect a certain form of financial support from politically connected firms, such as political contributions or tax revenue. In the 1990s, politically connected Russian businesses were more likely to be subject to price controls and more frequent inspections because it was beneficial to politicians (Frye, 2002). Not only do politicians require payback from firms, but firms are willing to give as well. According to Gehlbach's (2006) study on the tax compliance of firms in Eastern Europe and in the former Soviet Union, firms hiding revenue from tax authorities is associated with the firm-level satisfaction with state-provided goods and services. Because larger and politically connected firms receive better service from the government, they are less willing to hide revenue, i.e., they are willing to pay more tax.

Firms help politicians stay in power through excess hiring and paying more taxes and thus enjoy the privilege of being influential in the government policies and regulations they are interested in. More contributions from the focal firm, i.e., spending more on maintaining a stable economy, would therefore lead to a stronger relationship with incumbent politicians and bureaucrats, i.e., a higher level of influence.

H1: The more firms contribute to the national economy (from a government perspective), the stronger business-government relations they are likely to have.

3.2. Dealing with Government Officials

In China, firms with political connections enjoy larger bank loans, have access to more capital sources and can borrow capital more cheaply when compared with their non-connected counterparts (Li et al., 2008). Pakistan shows the same evidence (Khwaja & Mian, 2005). The difference in access to capital is due to the lending practice of state-owned banks, and this difference increases as business-government relations grow stronger (Brandt & Li, 2003; Che, 2002). A cross-national study shows that firms with controlling shareholders or top managers who are members of legislatures or national governments enjoy easier access to debt financing and lower taxation (Faccio, 2006). Thus, firms that do not have such political connections might need to bribe their way out.

In transition countries where institutions are absent and government operating procedures are not so transparent, government officials can easily hinder business operations as they have virtually full control of licensing and government contract bidding. For politicians and top-level bureaucrats who are already benefiting from firms' contributions in lowering the unemployment rate and increasing tax revenue, they cannot be too aggressive when depriving these firms of personal financial benefits because they may risk losing support from these firms. For lower-level government officials whose tenure and promotion are less related to the economic environment, they are more likely to seek personal benefits, i.e., bribes, from firms when firms are requesting favor from them in all types of licensing and government contract bidding needs. As there are few institutions or monitoring mechanisms in transition countries to monitor low-level operating government officials, the relationship between these officials and business firms is particularly imbalanced. To balance an imbalanced dyadic relationship, we can introduce an additional actor as any two actors in a triadic relation can form a coalition to act against the third actor (Emerson, 1962). Therefore, firms may build good relationships with politicians and top-level bureaucrats who make decisions on policy changes and more importantly, "rule" the low-level government officials who implement policies and procedures. Since policy-making politicians usually

are supervisors of lower-level operating government officials, firms with strong relationships with these politicians have relatively stronger bargaining power than firms that do not have such relations when dealing with low-level government officials. For the above reasons, firms that contribute more and have stronger relations with the government may be able to pay lower bribes to government officials and have higher priority when waiting for some administrative work to be done. Therefore, we hypothesize that firms with stronger business-government relations are likely to have lower costs in dealing with government officials.

H2: The stronger the business-government relations firms have, the lower the costs they need to pay are when dealing with government officials.

3.3. Influence of Business-Government Relations

In previous sections, we discussed how firms build and maintain relations with politicians and government through providing a stable economy and how firms may benefit from these relations when they need to deal with government officials. It is expected that firms benefitting from lowered costs of business and a less competitive environment will transform these advantages into opportunities for growth and investment. On the one hand, firms with strong government relations do benefit from those advantages. On the other hand, however, these relations do not come for free, and firms need to pay certain costs to build and maintain these relations. In the first hypothesis, we considered tax compliance and excess hiring costs for building and maintaining government relations. Paying more tax means that firms are left with less profit, and hiring more redundant employees means that firms are more inefficient and the payroll is relatively high compared to the firms' sales. As a result, building business-government relations through contributing to national economies could result in firms making smaller profits and thus having less money left to put into innovation and reinvestment.

Having strong government relations means that firms are capable of influencing policies and regulations in their industry and the regions that they operate in, so they can create a relatively less competitive environment, and the subsequent monopolistic environment usually hinders motivation in investing in innovation. Moreover, the relations built are usually location and industry-specific as firms' contributions to the economy are mainly observed by politicians and bureaucrats who are working in that specific geographical and industrial area. When firms move outside their attached geographical and industrial areas, the benefits they can get from the relations built diminish or even disappear. Thus, firms with established relationships with politicians and bureaucrats have less incentive and motivation to innovate or diversify than other firms without such relations. Therefore, we argue that firms with strong government relations are less likely to alter their production lines and production plants.

H3: Firms with stronger business-government relations are less likely to restructure their production mix.

4. DATA AND METHODS

4.1. Sample

To test the costs and benefits of business-government relations and further analyze its impact on firm development, we use data from the World Bank's Enterprise Surveys (World Bank, 2002a, 2002b). The Enterprise Surveys comprise data from over 120,000 manufacturing and service providing firms in 125 developing countries. The dataset has been used in other research, such as in entrepreneurship (e.g., Muravyev, Talavera, & Schafer, 2009) and corruption (e.g., Kenny & Soreide, 2008). As business-

government relations are still a sensitive topic in many countries, particularly when there are questions about bribes and gifts that firms give to government officials, not all participating firms reveal their information on this topic. The survey used, however, attempts to solve this problem by asking sensitive questions indirectly. Questions concerning sensitive activities require respondents to comment on a hypothetical similar firm rather than admitting that the firms have engaged in these activities.

Although the World Bank Group has conducted the Enterprise Surveys (WEBS) every three years since 2002, in 2006, it changed the questionnaire dramatically so that some constructs of interest in this study are omitted. Thus, we can only use survey data from 2002 to 2006. This paper focuses on transition economies. The empirical analysis includes all the 25 transition economies surveyed by the WEBS: Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, China, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, the Russian Federation, Serbia and Montenegro, Slovenia, Tajikistan, Ukraine, and Uzbekistan. After dropping observations with meaningless values and missing key independent variables, there are 5,094 observations from 25 industries.

To increase data quality, the WEBS was conducted through face-to-face interviews with company managers and owners. However, because some questions in the surveys such as bribery activities, the ability to affect government policies, and investment activities of firms are sensitive questions, the number of firms that responded to all these sensitive questions was smaller than the number of respondents. We conducted a standard mean comparison test to assess the non-response bias and found that non-response bias happens across countries but not within countries. Thus, the inclusion of a country dummy variable can potentially solve the problem. We also used logistic regression models to control for the baseline information to estimate the probability of response for each dependent variable. The reciprocals of these probabilities are used as non-responding weights in the empirical analysis.

4.2. Variables

In the first stage analysis, we study the relationship between firms' involvement in maintaining a stable economy and the strength of business-government relations. The dependent variable, business-government relations, measures firm-level relations with incumbent politicians and bureaucrats. Firms with better relationships with incumbent politicians and bureaucrats are more likely to influence government policies and regulations. Thus, the influential power of firms toward changes in laws and regulations is a good proxy for business-government relations. In the survey, there is a question that asks respondents about the perceived influence on changes in laws and regulations that the focal firm has. The question is "How much influence do you think the following groups actually had on recently enacted national laws and regulations that have a substantial impact on your business?" Respondents could choose from 0 (no impact) to 4 (decisive impact). In addition to asking about the influence of (a) the focal firm, the question also asked about the perceived influence of (b) other domestic firms, (c) dominant firms or conglomerates in key sectors of the economy, (d) individuals or firms with close personal ties to political leaders, and (e) foreign firms. Firms' perceptions of influence are potentially affected by differential item functioning (DIF) such that identical firms may have unequal probabilities in answering questions about their own influence on government regulations and policies in the same way (Embretson, & Reise, 2000). The responses of the perceived influence questions show that the item has a high possibility of DIF as most firms responded that no one has any influential power and that the perceived own influence is associated with ratings of other firm categories. To account for the possibility of DIF, we used other firms' influential power perceived by the focal firm as a reference. To reduce the effect of bias towards any firm category, we used the average of four firm categories (b) to (e) as the

reference. The perceived influence score is calculated as follows: business-government relation=a-average (b, c, d, e).

The main independent variables for the first stage analysis are the costs that firms must pay to build business-government relations. This set of independent variables includes tax compliance and excess employees that a firm hires. Tax compliance is the percentage of annual sales reported for tax purposes. It is captured by the question "Recognizing the difficulties many enterprises face in fully complying with taxes and regulations, what percentage of total sales would you estimate the typical establishment in your area of activity reports for tax purposes?" This variable measures the level of strategic accounting. The less strategic accounting the focal firm performs, the more tax a firm needs to pay, and value of the tax compliance variable increases. This variable is predicted to have a positive association with perceived influence, i.e., the more tax a firm pays, the more influential a firm is.

Excess hiring is the percentage of excess employees that a firm has compared to its perceived optimal size. The measure is derived from 100% minus the answer to the question "If you could change the number of regular full-time workers you currently employ without any restrictions (i.e., without seeking permission, making severance payments, etc.), what would be your optimal level of employment as a percentage of your existing workforce?" We used a dummy variable, i.e., whether a firm hires non-necessary employees, and the natural log of the excess percentage for empirical analysis. The excess hiring variables are predicted to have positive associations with perceived influence. Firms that hire excess (non-necessary) employees are more influential than firms that do not hire more than the amount they need, and the more non-necessary staff hired, the more influential a firm is.

In the second stage, business-government relations are used as the key independent variable instead to investigate the benefits from building relationships with incumbent politicians and bureaucrats and to study the impact of government relations on firm behavior and development. In this stage, there are two sets of dependent variables. The first set of dependent variables measures costs in dealing with government officials. This set of variables includes the bribes that firms pay to government officials to "get things done", bribes that firms pay to secure government contracts, and the efficiency of senior management dealing with government administrative paper work and procedures.

Bribery is captured as a percentage of annual sales in the question "We have heard that establishments are sometimes required to make gifts or informal payments to public officials to "get things done" with regard to customs, taxes, licenses, regulations, services, etc. On average, what percentage of annual sales value would such expenses cost a typical firm like yours?" Contract bribery is captured as a percentage of contract value to the question "When establishments in your industry do business with the government, how much of the contract value is typically expected in gifts or informal payments to secure the contract?"

Efficiency is captured as a negative value of a percentage of time in a week to the question "In a typical week, what percentage of senior management's time is spent on addressing requirements imposed by government regulations [e.g., taxes, customs, labor regulations, licensing and registration] including dealings with officials, completing forms, etc.?"

Firms with stronger business-government relations are expected to have lower operational costs. Thus, coefficient signs of key independent variables in relation to bribery and contract bribery are expected to be negative, and the coefficient sign of efficiency is expected to be positive, i.e., stronger relations reduce the bribes that need to be paid, and the company is more efficient at administrative work.

The second set of dependent variables measures the consequences of having business-government relations. This set of variables includes new production lines initiated, closed obsolete production lines, new plants opened and old plants closed. The question asks whether the firms were involved in these activities in the past three years. Firms with strong government relations, on the one hand, benefit from paying less bribes, but on the other hand, they need to pay more taxes and hire excess numbers of employees thereby becoming inefficient with less money to reinvest. Firms with strong government relations can operate in less competitive environments through influencing policy-making officials to create a more favorable business environment for the firms and the relations built are usually location and industry-specific as firms' contributions to the economy are mainly observed by high-level officials who are working in that specific geographical and industrial area; therefore, these firms have less incentive and motivation to innovate or diversify than other firms in a more competitive environment. Thus, coefficient signs of the key independent variables are predicted to be negative.

In both stages, we control for other factors that may influence the dependent variables, including firm age, firm size, and two ownership dummy variables – foreign dominant ownership and government dominant ownership because firms owned by foreign shareholders and government tend to be more influential in relation to business-related policies, industry controls, country controls and annual controls. As total assets of individual firms were not available from the survey, firm size is measured in logarithms of the number of employees.

4.3. Analysis

We test the hypotheses using pooled OLS for most analysis and a pooled logit model for the dummy independent variable, R&D involvement. Although the survey is conducted in different years and it is highly possible that some firms have more than one record in the dataset, the dataset does not provide a firm identifier, which is required for longitudinal analysis. An ordinary least square (OLS) regression model is used to analyze the relationship between the level of political contribution, in terms of excess hiring and tax compliance, and business-government relations. In addition, an OLS and logistic models are used to analyze the benefits that firms can obtain from business-government relations when dealing with government officials and the impact of business-government relations on firm behavior. All analyses are regressed on a country-industry level cluster to generate a robust standard error.

5. RESULTS

Table 1 summarizes the statistics of the variables. The unreported bivariate correlations show that business-government relations are positively correlated with tax compliance and excess labor, and negatively correlated with total bribes, bribes paid for government contracts, efficiency, and operational restructuring. While the two variables capturing bribes, total bribes and bribes paid for government contracts are generally expected to be highly correlated because they are used to capture the same underlying firm behavior, i.e., bribery, the actual data show the contrary. This is because a bribe paid to secure government contracts is associated with the industry that the focal firm is in, while the value of total bribes is not. In some industries, most firms do not involve themselves in government-related contracts and thus do not need to pay any bribes; however, they still need to pay bribes to help their operations run smoothly.

5.1. Providing Support to Policy-Making Politicians

Politicians rely on firms to provide a stable economy so that they can enjoy longer tenure. In return, politicians make and change policies and regulations according to these firms' interests. H1 predicts

Table 1: Summary Statistics

Variable	N	Mean	Std. Dev.
Gov. Relations	5,094	-0.977	1.205
Firm age (years)	5,094	25.189	19.470
Firm Size (Permanent workers ln, t-1)	5,072	3.281	1.743
Foreign Firm	5,094	0.067	0.251
State-owned firm	5,094	0.128	0.334
Tax compliance (% of sales reported)	4,567	83.398	24.452
Excess labor	4,950	0.264	0.441
% Excess labor (ln)	4,950	5.032	12.295
Total bribes (% sales)	4,647	1.693	3.728
Bribes for Gov. contracts (% of value)	4,522	1.783	4.579
Efficiency	4,853	8.406	12.406
New product line initiated in past 3 years	5,071	0.396	0.489
Obsolete product line closed in past 3 years	5,066	0.222	0.416
New production plant opened in past 3 years	5,066	0.146	0.354
Old plant closed in past 3 years	5,062	0.119	0.324

firms that devote more resources to maintaining a stable economy are more likely to have stronger business-government relations. Table 2 shows the estimations of this hypothesis. In Table 2, columns (1) and (2) show that firms reporting more taxes have stronger business-government relations. The result is statistically significant; the magnitude of the result, however, is small.

Table 2: Tax Compliance, Excess Labor and Business-Government Relations

	Gov. Relations (Perceived Influence)									
	All	**All**	**All**	**All**	**State-owned**	**Private**	**All**	**All**	**State-owned**	**Private**
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**
Tax compliance	0.002**	0.002**								
	(0.001)	(0.001)								
Excess Labor			0.081*	0.072*	-0.086	0.095**				
(Dummy)			(0.043)	(0.042)	(0.113)	(0.044)				
Excess Labor							0.022	0.019	-0.028	0.029*
(ln, %)							(0.016)	(0.016)	(0.041)	(0.017)
Age	0.003*	0.003*	0.002*	0.002*	0.001	0.003*	0.002*	0.002*	0.002*	0.003*
	(0.002)	(0.001)	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)	(0.280)	(0.078)
Size	-0.011	-0.009	-0.037	-0.034	-0.058	-0.017	-0.035	-0.033	-0.062	-0.015
	(0.040)	(0.040)	(0.039)	(0.039)	(0.137)	(0.041)	(0.039)	(0.039)	(0.136)	(0.041)
$Size^2$	0.009	0.008	0.011*	0.010*	0.019	0.007	0.010*	0.010*	0.020	0.007
	(0.006)	(0.005)	(0.006)	(0.006)	(0.015)	(0.006)	(0.006)	(0.006)	(0.015)	(0.006)
Foreign	-0.010	-0.012	0.012	0.007		-0.001	0.012	0.007		0.001
	(0.072)	(0.071)	(0.069)	(0.068)		(0.068)	(0.069)	(0.068)		(0.069)
State-Owned	0.212***	0.202***	0.229***	0.220***			0.229***	0.219***		
	(0.065)	(0.065)	(0.060)	(0.060)			(0.060)	(0.060)		
Constant	-0.692***	-1.667***	-0.455**	-1.131***	-0.946	-1.253***	-0.461**	-1.136***	-0.945	-1.260***
	(0.209)	(0.219)	(0.206)	(0.215)	(0.684)	(0.217)	(0.206)	(0.215)	(0.687)	(0.216)
Non-response weighting	No	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes
N	4269	4269	4630	4630	624	4006	4630	4630	624	4006
k	426	426	429	429	238	411	429	429	238	411
R^2	0.158	0.159	0.147	0.147	0.177	0.142	0.147	0.147	0.177	0.141
RMSE	1.109	1.105	1.113	1.101	1.223	1.090	1.114	1.110	1.223	1.091

Notes: Results from OLS regressions, with industry, country and year dummies (not reported). Robust standard errors clustered by k country-industry clusters are in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$

Columns (3) and (4) of Table 2 test whether having excess labor helps firms to secure business-government relations, and the result is positive. Columns (7) and (8) of Table 2 show that, although the excess labor variable has the correct predicted sign, it is not statistically significant. There are two

plausible explanations. The first is that firms with more excess labor are more likely to have higher numbers of employees, i.e., the effect of excess labor may overlap that of firm size. The second reason is that there are two groups of firms in the sample, and they behave differently and cancel each other's effect. Thus, we separate the sample into state-owned firms and private firms and re-estimate the excess labor models. The results (columns 5 and 9 of Table 2) show that having excess labor does not affect business-government relations of state-owned firms. For private firms (columns 6 and 10 of Table 2), having excess labor strengthens their relations with the government, and the more excess labor they have, the stronger the relationship is and the more the firms are able to influence government policies and regulations that they are interested in. Such results provide further evidence that contributions to reducing the unemployment rate help private firms to build and sustain relations with policy-making politicians and bureaucrats. Therefore, H1 is supported.

5.2. Dealing with Operating Government Officials

H2 predicts that business-government relations help firms deal with government officials easily and, in turn, reduce firms' operational costs. We analyze the relationship of business-government relations with three types of costs: bribery paid to "get things done", bribery paid to secure government contracts and time spent dealing with government officials and procedures with administrative works. The results are shown in Table 3. Columns (1) and (2) of Table 3 show the relationship between business-government relations and estimated bribes paid to government officials. We find that firms are more influential over laws and regulations, i.e., have stronger business-government relations and pay less bribes to "get things done". Columns (3) and (4) of Table 3 show that firms with stronger business-government relations pay less to secure government contracts. From columns (5) and (6) of Table 3, senior management from firms with strong business-government relations spend less time dealing with government officials and procedures with administrative works; the result, however, is not statistically significant. Thus, we can conclude that firms with strong government relations benefit from lower operational costs by paying less in bribes, while there is no guarantee that they can enjoy more efficient service from government officials. Thus, H2 is only partially supported.

Table 3: Business-Government Relations and Costs in Dealing with Government Officials

	Bribe (% of sales)		**Contract Bribe (% of contract value)**		**Efficiency**	
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Gov. Relations	-0.214***	-0.215***	-0.356***	-0.36***	-0.112	-0.119
	(0.046)	(0.048)	(0.065)	(0.068)	(0.168)	(0.178)
Age	-0.001	-0.002	-0.009***	-0.011***	-0.003	-0.003
	(0.004)	(0.004)	(0.004)	(0.004)	(0.011)	(0.012)
Size	-0.098	-0.056	0.231	0.227	0.774	0.663
	(0.103)	(0.105)	(0.152)	(0.164)	(0.472)	(0.506)
$Size^2$	-0.01	-0.014	-0.044	-0.044**	-0.079	-0.067
	(0.013)	(0.013)	(0.018)	(0.019)	(0.059)	(0.064)
Foreign	-0.160	-0.177	0.101	0.108	1.189	1.373
	(0.166)	(0.171)	(0.274)	(0.283)	(0.815)	(0.851)
State-Owned	-1.063***	-1.087***	-0.762***	-0.741***	0.288	0.300
	(0.134)	(0.139)	(0.227)	(0.230)	(0.568)	(0.590)
Constant	3.148***	1.22***	1.626**	1.812**	5.143**	11.742***
	(0.717)	(0.404)	(0.692)	(0.732)	2.175	2.483
Non-response weighting	No	Yes	No	Yes	No	Yes
N	4405	4092	4366	4053	4524	4211
k	421	382	425	386	352	313
R^2	0.089	0.089	0.069	0.069	0.064	0.064
RMSE	3.210	3.199	4.460	4.502	11.562	11.691

Notes: Results from OLS regressions, with industry, country and year dummies (not reported). Robust standard errors clustered by k country-industry clusters are in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

5.3. Impact on Firm Behavior

After looking at the costs and benefits of developing business-government relations, let us turn to how these government relations influence firm behavior. Table 4 shows the analyses of consequences of business-government relations in terms of production mix (production lines and production plants) restructuring. Firms with stronger relations with the government are less likely to introduce or shut down production lines, and they are less likely to open new production plants. Although the relationship between business-government relations and closing production plants has the correct sign, the result is not statistically significant. H3 is partially supported.

6. DISCUSSION AND CONCLUSION

This paper presents the costs and benefits of developing business-government relations and analyzes the consequence of business-government relations on firms' further development in the context of transition economies. Although business-government relations are a form of exchange, previous studies mostly focus on the benefit side of firms, while comparatively few studies examine the costs that firms need to pay for such exchange and the consequence of paying such costs in the long run.

Table 4: Business-Government Relations and Firm Behavior

	New production line initiated	**Obsolete production line closed**	**New plant opened**	**Old plant closed**
	(1)	**(2)**	**(3)**	**(4)**
Gov. Relations	-0.100**	-0.274***	-0.139**	-0.133
	(0.043)	(0.053)	(0.071)	(0.083)
Age	-0.007**	0.003	-0.014**	0.013***
	(0.004)	(0.004)	(0.006)	(0.005)
Size	0.561***	0.394***	0.755***	0.426**
	(0.121)	(0.14)	(0.226)	(0.188)
$Size^2$	-0.044	-0.022	-0.051*	-0.028
	(0.016)	(0.018)	(0.027)	(0.023)
Foreign	-0.321	-0.291	-0.118	0.082
	(0.220)	(0.232)	(0.316)	(0.344)
State-Owned	-0.322**	-0.048	-0.487	-0.484*
	(0.151)	(0.187)	(0.307)	(0.252)
Constant	-0.541	-1.286***	-5.010***	-2.584***
	(0.340)	(0.440)	(0.857)	(0.513)
N	2284	2243	1969	1965
k	203	191	145	145
R^2	0.094	0.102	0.132	0.077

Notes: Results from logistic regressions, with industry, country and year dummies (not reported). Robust standard errors clustered by k country-industry clusters are in parentheses. R^2 values reported are pseudo R^2. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

The empirical results show that in transition economies, firms that put more resources into providing a stable economy and helping politicians stay in their positions for a little longer, have stronger relations with the government and are more capable of influencing policies and regulations that are related to their business. The results also show that in transition economies, business-government relations can help firms deal with government officials because having strong relations with policy-making politicians can deter the rent-seeking behavior of government officials and ensure that they provide efficient service. Firms with strong business-government relations in transition economies are less likely to innovate or restructure their production mix, although such relations reduce their operational costs

and increase their efficiency. There are several possible reasons for this firm behavior. First, there are costs in building relations; second, the ability to influence policies and regulations may create a less competitive environment for the firm; and finally, business-government relations of this type are geographical and industrial-specific. For all these reasons, firms with strong relationships with high-level government officials have less motivation for innovation and reinvestment. Further research can explore this subject matter more deeply and attempt to find out the underlying reasons for this behavior.

This study awaits refinements in further study. This paper has its merits in that it presents an empirical test for some government relation building costs that are understudied by business scholars and the potential long-term effects of business-government relations on firm behavior, but the cross-sectional nature of the data does not allow the conclusion of a causal relationship. Further study needs to collect longitudinal data to explore the causal relationship between high-level and low-level business-government relations and use a firm identifier to control for unobserved firm effects in panel data analyses.

The paper has important managerial implications. It has been widely accepted and believed that business-government relations can help firms to access resources, get things done easier and even help improve performance. However, managers may not be aware that the benefits of business-government relations come with a cost that is so high that it would affect a firm's investment decision making and hinder future development. Thus, when building and maintaining business-government relations, managers should ensure that they can balance the costs and benefits to maintain reasonable future development.

To conclude, this paper explores indirect costs for firms in building good relations with policy-making politicians and studies how these relations help firms when dealing with policy implementing government officials. It also goes a step further to better understand the influence of business-government relations on firm decision making and firm development. Future studies can build on these ideas and go deeper into discovering more firm decisions or behaviors that are influenced by business-government relations and come to a better conclusion on how business-government relations affect firms in the long run.

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