

Bartlett, Will

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The performance of politically connected firms in South East Europe: state capture or business capture?

Will Bartlett

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The performance of politically connected firms in South East Europe: state capture or business capture?

Will Bartlett*

Abstract

This paper investigates the effects of the political connectedness of private sector firms in South East Europe on their business performance. This question is relevant to contemporary ideas about the importance of “state capture” in the region, and the paper provides a new perspective on the nature and consequences of this phenomenon. On the basis of evidence from empirical survey data as well as case study evidence, the paper concludes that political connections tend to undermine the business performance of the connected firms, with a potential negative impact on the economic development of the countries concerned. It is argued that this process is better described as “business capture” rather than “state capture”. The terminology is important as it indicates the directions in which policy might be directed to effectively manage this issue and improve the competitiveness of economies in the region. The average overall negative effect on business performance measured by employment growth is substantial but is found to be statistically significant only the services sector and in countries of the Western Balkans. The EU member states of the region appear to be relatively immune from the negative effects of business capture.

Keywords: Politically connected firms, state capture, Southeast Europe

* European Institute, London School of Economics and Political Science
Email: w.bartlett@lse.ac.uk

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Performance of politically connected firms in South East Europe: state capture or business capture?

1. Introduction

The concept of state capture has risen up the policy and research agenda in South East Europe (SEE) in recent years. State capture has been defined in different ways, but generally refers to the common theme of the existence of cosy relations between political and business elites, and in particular the way in which powerful business interests may engage in practices of bribery and corruption to influence public policy in their favour. The discussion of state capture in SEE has been conducted in the context of political developments focusing on the recent experience of democratic backsliding, competitive authoritarianism, and illiberal democracy (Kapidžić, 2020; Stojarova, 2020). In the Western Balkans in particular, it has been linked to the reversal of democratic reforms and a reversion to more authoritarian modes of governance (Bieber, 2018, 2020). These trends are thought to be associated with “strong links between political elites and certain business leaders” that have blocked the consolidation of democracy in order to enhance their own positions of power and privilege (Keil, 2018: 70). However, relatively little attention has been paid to the economics of state capture. This is puzzling because there is a large literature exploring the business performance of politically connected firms in a number of different national contexts. This paper addresses this gap by analysing the impact of political connections on business performance in SEE.

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The development of political connections by business firms has been especially important in transition and emerging economies where state institutions are weak. In the institutional haze, firms seek protection through political connections to counteract the lack of legal certainty offered by ineffective legal systems and the absence of a level playing field for doing business. Such political connectedness of firms may have either a positive or negative influence on business performance. On the positive side, political connections may provide privileged access to finance, enable firms to avoid regulatory barriers, obtain licences and permits more easily than other firms, and protect against commercial corruption and mafia attentions. On the negative side, political connections may be inimical to business success if they are associated with politically motivated business decisions, as investment and employment decisions may be biased in favour of political interests causing a misallocation of resources. If easy access to credit is enabled by political connectedness, the resulting investments may be wasteful or unprofitable. Political connections may also involve tunnelling and asset stripping of firms in favour of political sponsors.

In this paper I apply these ideas to the case of political connectedness in SEE. Following Yakovlev (2016) for the Russian case and Szanyi (2019) for the Hungarian case, I argue that the economic systems that have been established in SEE may also be best described as examples of “business capture” in which the state, and through it a dominant political elite, holds sway over the business sector and whose leading personalities are closely entangled with it. In this system, the political elite that dominates the state seeks to control the business sector through neopatrimonial networks of interconnections. In rare cases in which large firms have become potentially more powerful than the state, the latter has invariably stepped in to assert its control. In order to investigate these issues, this paper makes use of the EBRD BEEPS survey to identify the impact of such political connectedness on business performance in SEE.

The next section reviews the literature on political connectedness and state capture and identifies some examples of politically connected firms in SEE. Section 3 sets out the methodology and the data sources used and presents the descriptive statistics.

Section 4 presents the data analysis using non-linear regression modelling incorporating interactions between political connectedness and other categorical explanatory variables. The regression model emphasises the marginal effects of political connectedness on firm performance in SEE measured through the prism of employment growth. Section 5 presents the conclusions and policy implications.

2. Political connectedness and state capture

The concept of state capture first proposed by Hellman et al. (2003) can be distinguished from the classical concept of “regulatory capture” (Stigler, 1971) as being a form of high-level corruption. It is associated with the experience of the transition in Eastern Europe, especially in the former Soviet Union. While under socialism the state influenced the economy, under state capture the business sector “captures” the state. Hellman et al. (2003) distinguish two ideal types of state capture, distinguished by the difference between “captor firms” and “influential firms”. Captor firms, often newly established private businesses run by wealthy tycoons, use bribery and corrupt practices (not excluding the use of force) to buy influence among leading politicians and other state personnel. These firms are not influential in a political sense, and so have a need to use financial resources to buy protection in weak states where the rule of law is not well established. In the successor states of the former Soviet Union the tycoon owners of such firms have often gained enormous wealth on the basis of the privatisation of state-owned natural resources companies. In contrast, influential firms gain protection from the state through their *political connectedness*. Influential firms may operate under continuing state ownership, or they may be new private firms that have been established by members of the former nomenklatura – so called “red capitalists” – or they may have simply appointed serving politicians to their managing boards.

More recent interpretations of state capture in Central and Eastern Europe (CEE) have questioned the prevalence of captor firms in that transition region, where the new business elite does not have access to great wealth based on natural resources. Rather

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than businesses capturing the state, in CEE it seems that the state, in the form of dominant political parties, has captured key parts of the business sector. Innes (2014) argues that dominant political parties in CEE economies have captured the business sector through a process of what she calls “party state capture”, while Szanyi (2019: 2) calls this “business capture” (in contrast to state capture). Business capture is exercised through regulatory tools including the use of selective measures favouring politically aligned businesses, and public policies are adopted that shield politically connected firms from market competition. Business capture thus establishes a patronage state, which facilitates rent-seeking by politicians and other state personnel (Szanyi, 2019: 17). In the words of Madlovics and Magyar (2020) “[n]o longer are oligarchs or an organized underworld capturing the state, but instead a political enterprise, an “organized upperworld”, monopolizes political power and captures the economy, including the oligarchs themselves.” In such a system the business sector is captured by a political-economic clan that operates as a “pyramidal patronal network”. The political leadership in such a system has the power to confiscate the property of favoured businesses if they become too powerful, while political connections provide firms with protection from the arbitrary power of lower-level bureaucrats and privileged access to business loans, credits and contracts.

2.1 Political connectedness and firm performance

The phenomenon of business capture is closely connected to political connectedness of firms. It is not unique to South East Europe, or even to transition economies in general. In a study of newly privatised firms around the world, Boubakri et al. (2008) found that 35.5% out of a sample of 245 such firms had political connections, defined as having a politician or ex-politician on the company board. Such politically connected firms were found to be more prevalent in countries with lower levels of judicial independence.

Many studies of politically connected firms focus on the advantages this practice confers, such as providing protection from competitors, preferential access to finance,

tax privileges, and preferential access to government subsidies and bank loans. Much of the research has been conducted in China. Several studies found that politically connected firms obtain preferential access to credit (Liu et al., 2018). Having political connections in the form of independent directors linked to the ruling Party shields private firms from unfavourable government intervention (Wang et al., 2015). Chinese private firms that foster political connections with government officials are able to grow even in a weak property rights environment (Kung & Ma, 2018; Wu et al., 2018). Easy access to credit and other preferential advantages for politically connected firms have also been observed in Taiwan (Shen & Lin, 2016), Indonesia, (Fu et al., 2017), Korea (Shin et al., 2018) and Malaysia (Phan et al., 2020).

While the above studies identify the benefits to political connections, such as easier access to bank loans, others identify the downside of such advantages in the form of over-investment and inferior efficiency and competitiveness. For example, in the early stage of transition in Russia and Eastern Europe, Vishny and Shleifer (1994) argued that political connections adversely affect corporate decisions, distort incentives and lead to a misallocation of investment, and thus undermine a firm's competitiveness. In a much-quoted 45-country study, Faccio et al. (2006) showed that while politically connected firms are more likely to receive preferential corporate bailouts, they experience a lower rate of return on assets than bailed-out firms without political connections. They argue that this shows that political connections cause an inefficient allocation of capital. Boubakri et al. (2008), in the study cited above, found that the economic performance of politically connected firms is significantly worse than that of politically unconnected firms. For transition economies, Ruziev and Webber (2019) show that political connectedness among SMEs diverts investment loans and credits away from those without such connections, leading to an overall misallocation of resources with a negative impact on growth.¹ Several Chinese studies also came to

¹ This is the only other study of which I am aware that has used the BEEPS data to investigate the impact of political connectedness on business performance. However, the authors use different proxies for connectedness than I do, namely the "frequency of bribes and gifts" and the "receipt of government contracts". In my view, these represent imperfect measures of

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similar conclusions regarding the economic inefficiency of political connections. Ling et al. (2016) showed that politically connected real estate companies with easier access to long-term bank loans than others tend to overinvest, and as a result have a lower return on assets. Shi et al. (2018) shows that politically connected independent directors destroy firm value because they are ineffective in monitoring managers' performance. Li et al. (2019) identified a negative relationship between political connections and economic efficiency in Chinese renewable energy firms. There are many other examples from around the world in which political connections lead to poor company performance. For example, a negative relationship between political connectedness and firm performance has been identified in Pakistan (Saeed et al., 2016) and in Korea (Schoenherr, 2019). In the latter example, political connections have enabled private firms to win government contracts, which have often been executed inefficiently and at relatively high cost.

2.2 Business capture and political connectedness in SEE

Scholars of South East European politics have identified the close linkages between the political and economic elites as a key characteristic of the political economy of the region, often referred to as "state capture". Keil (2018: p. 61, footnote 1) defines state capture as:

"efforts by either groups or individuals in the public and private sectors to influence, manipulate and shape laws, policies, regulations, decrees and other government policies to their advantage... in which actors take control over large parts of the institutional set-up in order to push a certain policy agenda and promote their own interests (see Hellman, Jones and Kaufmann 2000)."

political connectedness compared to the one used in this study since bribes and gifts may be needed only by firms that are not politically connected (i.e. captor firms rather than influential firms defined by Hellman et al. (2003)), while both connected and non-connected firms may receive government contracts.

While referring to the earlier work of Hellman and colleagues, this definition does not seem much different from that of Stigler's "regulatory capture". It defines state capture as an act of agency by the business sector to influence government policies and laws. In this paper, however, I investigate the linkages between the political and economic elites through the prism of political connectedness exercised through neopatrimonial networks. Considering the economic dimensions of such connectedness between the political elite and the business elite, such linkages can be characterised as "business capture" rather than state capture (Yakovlev, 2016; Szanyi, 2019). Such business capture is a system in which "public power is exercised mainly for private gain" (Innes, 2014). Another way of thinking about this is that the phenomenon of business capture that characterises CEE and SEE regions is a variant the "influential firms" discussed by Hellman et al. (2003) rather than their "captor firms" that were (and still are) prevalent in the former Soviet Union. Bieber (2018: 347-348; 2020: 109) describes state capture as the "control of state resources for illicit purposes by a small elite in control of the state [which is] the leadership of the ruling parties." This definition is more in line with the concept of business capture which I use in this paper.

Business capture is closely related to practices of clientelism and rent seeking by ruling political parties. Sotiropoulos (2018) identifies typical practices of ruling parties in the region, including offering plum contracts to favoured companies who give kickbacks to the dominant party in power, and the placement of party loyalists in prime positions in public enterprises both at national and local level. In addition, numerous examples of clientelism and its systematic use by ruling parties to attract votes and retain a hold on power has been documented in Croatia by Vuković (2019) and in Serbia and Kosovo by Cvejić (2016a, 2016b). Pavlović (2019a) provides examples from Serbia of contracts between the government and private firms with confidentiality clauses that are not transparent to public view, of public procurement contracts awarded to favoured companies, and of the (mis)allocation of public funds by state agencies to politically connected firms. Moreover, the privatisation process in Serbia has provided ample opportunities for rent-seeking bureaucrats and politicians to acquire firms

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which they have subsequently allowed to collapse while stripping their assets (Vujačić & Petrović Vujačić, 2016; Ivanović et al., 2019).

Numerous examples of political connectedness of private firms in SEE have been reported in the media and reports of international organisations. An investigation by the media group BIRN revealed the close connections between lighting companies from Serbia and Hungary and the ruling elites in both countries; it is argued that these connections enabled the companies to win contracts to provide street lighting in numerous towns and cities (Curic & Zöldi, 2019). In Kosovo, companies in the quarrying sector with political ties are alleged to have gained favourable contracts in road-building programmes (KDI, 2018: 16). In Montenegro, the former Prime Minister and his family owns a major bank and several private companies. During the 2008 financial crisis the bank was bailed out with public funds (Patrucic, 2009). In North Macedonia the process of privatisation created many politically connected firms. According to Boduszynski (2010: 167) “Macedonian privatisation policy turned out to be a fiasco, with most firms sold to SDSM [the Social Democratic Union of Macedonia] insiders at ‘preferential’ rates. The politically connected managers who acquired the larger firms and banks could also rely on their insider status to secure ... loans from the unprivatised and government-controlled banks.” In Slovenia, Domadenik et al. (2016) find that 16% of supervisory board members in private firms were politically connected over the period 2000-2010. They show that firms with politically connected supervisory board members have lower productivity than non-connected firms (Domadenik et al., 2016).

As mentioned above, the state has periodically imposed itself against business owners who have become so wealthy that they threaten the grip of the state over the business sector. One example of this phenomenon comes from Croatia, where privatisation in the 1990s transferred assets into the hands of a relatively small number of politically connected tycoons (Petričić, 2000). One of these was the agricultural and food-processing company Agrokor, which grew to become one of the largest companies in South-East Europe (Klepo et al., 2018). As privatisation began in the 1990s, Agrokor

acquired additional companies using privileged loans from Zagrebačka banka. The owner, Ivica Todorić, was well placed to acquire shares in these companies due to his relationship with leading politicians in the ruling party (HDZ – Croatian Democratic Union), including his school friend Nikola Valentić who was Prime Minister from 1993 to 1995. He also received support from the EBRD, which hailed Agrokor as a leading example of corporate success in the region. In June 2013, Agrokor’s cross-border expansion continued with the purchase of 53% of the shares in the Slovenian supermarket chain Mercator. The takeover was investigated by the Croatian Competition Agency, which despite finding that the merger would have anti-competitive effects gave its approval to the takeover, indicating the strong political connections enjoyed by the company (CCA, 2014). Following the takeover, the company’s combined earnings increased to €7 billion annually, employing a total of 60,000 employees in Croatia, Bosnia and Herzegovina, Serbia, and Slovenia, making it one of the largest private companies in the region (MacDowell, 2013). However, the company was saddled with €2.5 billion of debts, almost half of which were due to the takeover of Mercator. By early 2017, Agrokor owed €6 billion to creditors and suppliers, with the debt to creditors alone amounted to 10% of all non-financial corporate debt in Croatia (IMF, 2018). The company’s debt-fuelled expansion, assisted by connections to powerful individuals in the political elite, eventually led to disaster.

By early 2017 it became apparent that the company could not sustain its debt burden, and in January 2017 Moody’s downgraded Agrokor’s credit rating. The company reached a “standstill agreement” with its creditors to preserve liquidity and enable payment of suppliers. However, in April 2017, fearing an adverse public reaction leading to the possible fall of the government, a special law for companies in difficulty was passed which gave the state a key role in the crisis management of companies deemed too big to fail and mandating the appointment of a state administrator accountable to the Minister of Economy, bypassing normal insolvency procedures

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(Djuric & Jovanovic, 2019).² The reason for the implementation of this law was most likely the fear that a disorderly collapse could have triggered the fall of the government (Klepo et al., 2018). Under pressure from suppliers, who threatened to stop deliveries of all goods except fresh bread, Todoric handed over the management of the company to a state administrator (Milekić, 2017).

Several significant actors including political parties had supported the growth of Agrokor, and some leading politicians were connected to its fortunes (Ivanković, 2019). The credibility of the finance minister was at risk, as he had been a senior manager at the company during the period of the controversial takeover of the Slovenian Mercator supermarket group. In May 2017, the minister narrowly survived a vote of no confidence in the Croatian parliament. In early October 2017, a financial audit of Agrokor's assets revealed various accounting irregularities and the Administrator filed criminal charges against Agrokor's former management team, leading to the arrest of several senior executives. In December 2017 the Administrator announced a debt-equity swap through which several creditor banks would become the new owners of the company, bringing the extraordinary administration procedure to an end. Eventually, Ivica Todoric was found not guilty of wrongdoing at his trial in Zagreb in October 2020. However, the front-runner of the Croatian business sector had been brought to heel by the state.

Another example of an attempt by a neopatrimonial state to assert its interests over the business sector can be found in Serbia, where it is widely thought that many Serbian tycoons had become wealthy by manipulating political ties with the then-ruling Democratic Party in the post-2000 privatisation process (Pavlović, 2019a). One well known case is that of the businessman Miroslav Mišković who had taken part in the privatisation process, and by 2007 was ranked 891st on the Forbes list of the world's richest people (Pavlović, 2019b). The May 2012 elections brought to power a coalition

² The law only applied to very large companies, and the media quickly nicknamed the new law "Lex Agrokor".

government led by the Serbian Progressive Party (SNS). In fulfilment of voter expectations, a crackdown on corruption was initiated and Mišković was arrested in December 2012 along with eight others in connection with the privatisation of public road maintenance companies, through which the suspects were alleged to have gained an “illegal profit” by the Serbian Special Prosecutor for Organised Crime. In March 2016 the Belgrade High Court acquitted Mišković of the abuse-of-office charges but found him guilty of abetting tax evasion (Buckley & MacDowell, 2012). On appeal the latter charge has been referred back to the first-instance court for retrial. In 2019 the defendant was found again guilty by the Belgrade High Court and sentenced to two and a half years in prison (Stojanovic, 2019). Given the ability of the government to put pressure on the judiciary, this example of back-and-forth movement in a high-profile commercial law case illustrates the dominance of the political elite over even the most powerful businesses in Serbia.

Both these examples reveal the strong interconnections between the political and economic elites and the role of political connectedness in two SEE states. They demonstrate that the fortunes of even powerful businesspeople are at the mercy of yet more powerful political patrons and their pyramidal networks.

3. Methodology

Empirically, political connectedness can be viewed as one of several determinants of a firm’s business performance alongside more standard explanatory factors such as the size, age, and sector of operation of a firm. The effect of firm size on growth has been subject of much scrutiny. Some studies have shown a positive relationship between size and growth, given that larger firms have easier access to finance and may be dominant actors in the market (Singh & Whittington, 1975; Bentzen et al., 2012). Other studies have shown a negative relationship between size and growth which may result from smaller firms being further away from the industry optimal size, and from their greater flexibility and adaptability to changes in demand (Rogers et al., 2010). In SEE, Banerjee and Jesenko (2016) found a positive relationship between firm size and firm

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growth in the case of Slovenia, but they also found that this effect diminishes with size. For Croatia, Perić et al. (2020) found a similar positive relationship between firm size and growth in the period since the economic and financial crisis of 2008. It is also thought that age will have a negative effect on growth, because newer firms are more likely to incorporate more recent technology and be more innovative than older firms (Evans, 1897). The effect of the sector of activity is ambiguous because the growth of firms in different sectors depends largely on the evolution of demand for different products.

The literature on political connectedness of firms in transition and emerging economies has highlighted its ambiguous effects on business performance. As shown above, previous studies have identified a range of channels through which connectedness may affect firm performance. Some of these are likely to underpin a positive effect of connectedness of growth, through channels such as privileged access to loans and public sector contracts. There may also be offsetting negative causal influences between political connectedness and firm performance, since connectedness may lead to inefficient investment decisions as well as making firms more vulnerable to asset stripping. Since either of these potential outcomes may occur it is of interest to identify which of these two potential effects is dominant in SEE, or whether they balance each other out giving rise to an overall neutral impact of connectedness on business performance.

In this paper I take the growth of employment as an indicator of the business performance of firms in SEE. The focus on employment growth as a proxy for business performance is justified in cross-section research since at any point in time each firm faces more or less the same technology and so the capital-labour ratio required to produce a unit of output will be the same for all firms, granted that the historic capital stock will incorporate technologies of different vintages.³

³ It should be noted that the concept of business performance is multifaceted, and were robust data available it might be possible to widen the research to cover alternative dependent

The model which I propose to test therefore takes the following form:

$$\begin{aligned} \ln(\text{employment growth})_i & \\ &= \beta_0 + \beta_1 \ln(\text{size})_i + \beta_2 [\ln(\text{size})_i]^2 + \beta_3 \ln(\text{age})_i + \beta_4 [\ln(\text{age})_i]^2 \\ &+ \beta_5 \text{connected}_i + \beta_6 \text{sector}_i + \beta_7 \text{country}_i + \varepsilon_i \end{aligned}$$

where:

employment growth = [(E in year t – E in year t-3) / E in year t-3] (where E= number of permanent full-time employees) (continuous variable)

size = number of full-time employees in the firm in year t (continuous variable)

age = number of years since the firm was founded (continuous variable)

connected = whether the owner, CEO, top manager, or any of the board members in political position (0-1 dummy variable)

sector = manufacturing or services sector (0-1 dummy variable)⁴

country = country in which firm is based (0-1 dummy variable)

i = individual firm

ε = disturbance term

The model explains business performance of firms, proxied by employment growth, as a function of the size of firms (measured by employment), the age of firms, the broad sector in which they operate and whether a firm has political connections. Squared terms in size and age take account of non-linearities in these two variables. Due to the skewed distribution of firms' employment growth rates, I use the natural logarithm of the employment growth rate which has an approximately normal distribution. Since it is not possible to take a logarithm of a negative number, I shift the axis by one unit by adding 1 to the employment growth rate before taking the logarithm. Firm size and age also enter in log form, so the elasticity of employment growth with respect to size and age of firm that is relatively straightforward to determine.⁵ The effect of

variables such as profitability and market penetration indicators. However, since such data is not readily available, I would argue that reliance on employment growth of the firm is a reasonable working proxy, especially over a short three-year period.

⁴ The firm's sector is based on the firm's main activity and product or service – the services sector includes wholesale and retail trade, construction and other services activities.

⁵ For example, the elasticity of employment growth with respect to size is equal to $[\beta_1 + 2\beta_2 \ln(\text{size})]$

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connectedness on employment growth is given by the coefficient value β_5 , the effect of sector is given by the coefficient β_6 , while the effect of individual country characteristics is given by the coefficient value β_7 . In estimating the model in Table 3 below I also allow for interaction effects between connectedness and sector, and connectedness and country.

4. Results

Table 1. Descriptive statistics for main variables for selected SEE countries

	<i>Mean</i>	<i>Standard deviation</i>	<i>Minimum</i>	<i>Maximum</i>	<i>N</i>
Employment size (year t)	91.98	301.51	1	11,382	3,403
Employment size (year t-3)	86.74	314.08	0	10,889	3,126
Age of firm (years)	21.83	15.50	3	206	3,453
Employment growth (3 years)	0.1506	1.428	-0.937	50.000	3,123
Politically connected (yes=1 no=0)	0.045	0.208	0	1	3,455
Sector (manufacturing=1 services=0)	0.434	0.496	0	1	3,466

Source: BEEPS VI survey

The BEEPS survey⁶ provides an ideal tool to analyse the nature of political connectedness of firms and its economic effects in South East Europe. The sixth round of the BEEPS survey (BEEPS VI) was carried out in 2018-2020 and covered approximately 25,733 enterprises in 38 countries. This paper uses data from the survey for Albania and Bulgaria and all the countries of former Yugoslavia (Bosnia and Herzegovina, Croatia, Kosovo, Montenegro, North Macedonia, Serbia, and Slovenia) covering 3,466 firms, most of which were surveyed in 2019. Table 1 shows the

⁶ Formally, the “EBRD-EIB-World Bank Business Environment and Enterprise Performance Survey (BEEPS) VI”.

descriptive statistics of the key variables that are used in the model that is analysed in the next section.

Within the sample, the mean size of firms was 92 permanent full-time employees at the time of the survey, having increased from an average of 87 employees three years prior. Economic growth was proceeding apace in the region at this time (before the outbreak of the corona virus pandemic) and this is reflected in a 15% mean of employment growth over this period, or about 5% per annum on average. The variation of growth is large, with some firms shrinking and other fast-growth firms expanding at a rapid rate. Within the sample about 43% of firms are in the manufacturing sector, with the rest in various service activities including retail trade, wholesale trade, construction and other service activities. Finally, about 4.5% of the firms have political connections, defined as whether the owner, CEO, top manager, or any of the board members in political position, ranging from 2.5% in Bulgaria to 10.7% in Montenegro. In absolute numbers, there are 156 politically connected firms in the sample, ranging from 10 politically connected firms in the North Macedonian sample to 30 politically connected firms in the Bosnia and Herzegovina sample.

Table 2. Characteristics of politically connected firms by country, age, size and growth

Country	N	Mean age (years)			Mean size (permanent full-time employees)			Annual employment growth		
		unconnected	connected	all	unconnected	connected	all	unconnected	connected	all
Albania	377	15.7	20.6	16.0	70.1	110.6	72.0	6.5%	10.3%	6.7%
Bosnia & Herzegovina	362	22.3	27.5	22.7	97.1	77.9	95.4	9.4%	1.6%	8.6%
Bulgaria	772	19.1	18.3	19.1	77.4	329.3	83.6	1.6%	2.3%	1.6%
Croatia	404	26.2	25.8	26.2	108.6	88.8	107.9	5.7%	1.1%	5.5%
Kosovo	271	18.4	23.3	18.6	35.8	52.8	36.7	3.9%	0.4%	3.7%
Montenegro	150	21.6	29.8	22.4	66.7	98.3	70.1	2.6%	3.1%	2.7%
North Macedonia	360	22.1	33.8	22.4	85.7	193.4	88.7	9.2%	-2.3%	8.9%
Serbia	361	23.3	23.7	23.4	119.9	515.7	140.0	3.8%	-2.6%	3.5%
Slovenia	409	27.4	27.1	27.4	102.4	57.5	100.7	5.5%	4.5%	5.4%
Total	3466	21.7	25.2	21.8	87.5	170.6	91.3	5.2%	2.2%	5.0%

Source: BEEPS VI survey

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The age and size of firms varies across countries (see Table 2). The average age of firms ranges from 16 years in Albania to 27 years in Slovenia. Politically connected firms tend to be slightly older than unconnected firms and almost twice as large. However, this pattern is not uniform. There is little difference in the age of politically connected and unconnected firms in Bulgaria, Croatia, Serbia, and Slovenia. The pattern of size differences is reversed in Bosnia and Herzegovina, Croatia, and Slovenia. The data also show that, on average, being politically connected appears to reduce annual employment growth of the sample firms by about 3 percentage points.

The estimation of the model is shown in Table 3. It begins with the most parsimonious version, with three explanatory variables – size and age and connectedness of the firms, for the SEE region as a whole (model 1). Following that, the squared values of the size and age variables are added to account for non-linearities in these variables (model 2). Model 3 brings in the sector variable, allowing this to interact with connectedness to identify the separate effect of connectedness across sectors. Model 4 brings in the individual countries as explanatory variables (as 0-1 dummies), while model 5 allows for the additional interaction of country by connectedness to identify differences in the influence of political connectedness across countries. The model is estimated using ordinary least squares (OLS). The Breusch-Pagan test of heteroscedasticity is used to identify whether the OLS assumption of constant variance of the disturbance term can be rejected. Where the assumption of constant variance of the disturbance term is rejected, robust standard errors are estimated. The model is estimated using the STATA econometrics package.

The estimation of a stripped down linear version of the model in column 1 shows that the natural log of employment growth is positively related to firm size and negatively related to firm age, both at a 1% level of significance. The elasticity of the natural log of (3-year employment growth+1) to firm size is 0.044, so that a 1% increase in size is associated with to an annual 4.4% increase in employment growth over three years, or 1.5% on an annual basis. Similarly, the elasticity with respect to age is 0.094, more than double the effect of size, but in the opposite direction. Overall, the estimated model

shows that younger and larger are firms, the faster is their employment growth and vice versa.

Table 3. Determinants of employment growth (dependent variable)

	1	2	3	4	5
Insize	0.044***	0.138***	0.144***	0.141***	0.137***
[Insize] ²		-0.013***	-0.013***	-0.013***	-0.012***
Inage	-0.094***	-0.229***	-0.244***	-0.230***	-0.233***
[Inage] ²		0.023**	0.0265**	0.023**	0.024**
connected (0,1)	-0.051*	-0.045*	-0.067*	-0.068*	-0.079
manufacturing (0,1)			-0.046***	-0.040***	-0.040***
manufacturing*connected			0.048	0.040	0.028
constant	0.195***	0.234**	0.258***	0.267***	0.272***
country dummies	No	No	No	Yes	Yes
country*connected	No	No	No	No	Yes
F	33.68***	33.68***	16.72***	18.37***	12.53***
Adjusted R-squared	0.056	0.056	0.071	0.077	0.079
Breusch-Pagan χ^2	6.39**	6.39**	3.47*	2.00	0.83
Robust standard errors	Yes	Yes	Yes	No	No
Average marginal effects					
dy/dx (Insize)	n/a	0.051***	0.053***	0.054***	0.053***
dy/dx (Inage)	n/a	-0.091***	-0.088***	-0.094***	-0.094***
Contrasts of predictive margins					
1. connected (yes vs. base)	-0.051*	-0.045*	-0.043*	-0.048*	-0.054**
2. connected (services)	n/a	n/a	-0.067*	-0.068**	-0.068*
3. connected (manufacturing)	n/a	n/a	-0.019	-0.028	-0.040

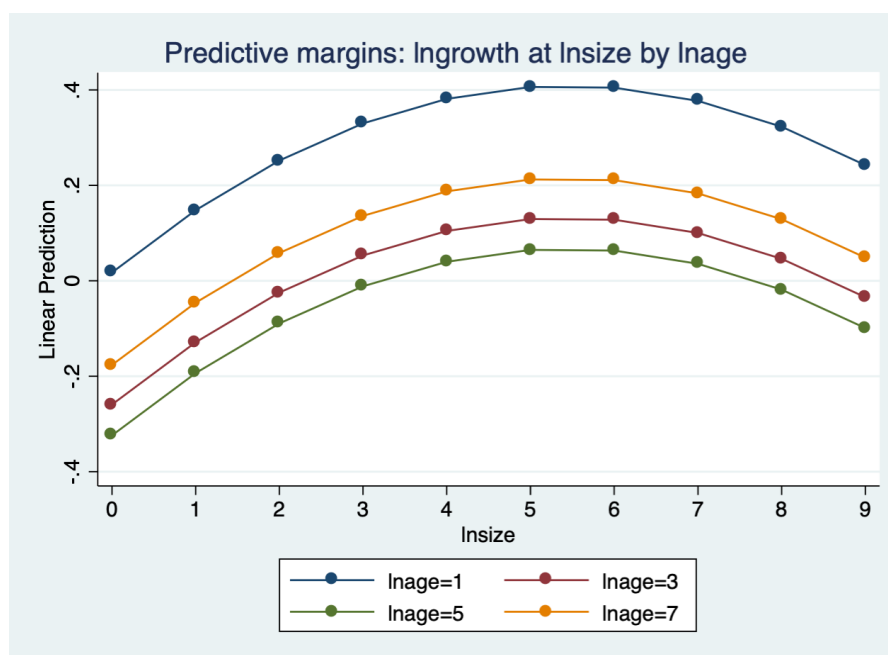
Source: BEEPS VI. Note: dependent variable $\ln(\text{employment growth rate} + 1)$. The Breusch-Pagan χ^2 is a test for heteroscedasticity. Estimation is made using OLS in STATA. In cols. 4 & 5 robust standard errors are presented. Note: Equations differ by form of interaction as follows (1) no interaction (2) Insize and Inage squared (3) sector*connected (4) sector*connected with country dummies (5) sector*connected with country*connected and country dummies.

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The estimated model also shows that, in SEE, political connectedness has a significant negative effect on firm performance, as measured by firm's employment growth. The effect is significant at the 10% level (bordering on the 5% level of significance). It shows that, controlling for other factors, firms that are politically connected can expect to grow at an annual rate 1.66 percentage points lower than unconnected firms.⁷

Column 2 shows the effect of adding non-linear terms for size and growth. The squared values are significant at the 1% level. In the case of firm size, employment growth increases up to a point, but for larger firms it decreases giving rise to an inverted U-shape. The opposite is true for firm age. Figure 1 portrays this effect. The fastest employment growth is found in young firms aged around 3 years with a size of between around 200 employees.

Figure 1. Predictive margins of $\ln(\text{employment growth}+1)$ by $\ln(\text{firm size})$ by $\ln(\text{age of firm})$

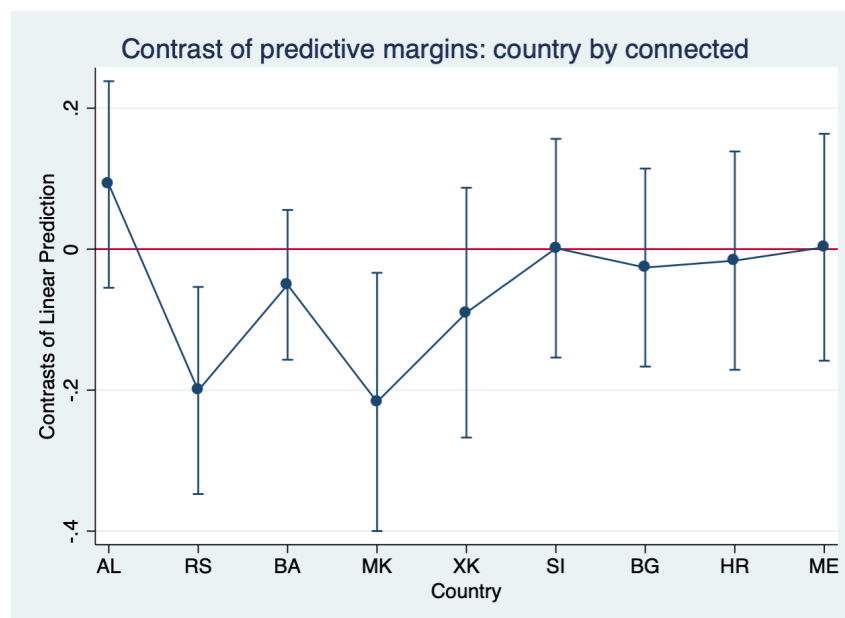


Source: Table 1, column 2

⁷ Since the employment growth is measured over three years, the coefficient on connectedness of -0.051 is divided by 3 to give an annual effect of -0.0166.

Columns 3-5 introduce interactions of connectedness with sector and country. The full effects of the interaction terms are not revealed by the simple coefficients in the main regression table. Instead, it is necessary to inspect the marginal effects and the contrasts of the predictive margins, which take into account both the interaction and the main effect together (Brambor et al., 2006). These are shown in the last three columns of Table 3. Row 1 shows that politically connected firms have worse business performance than unconnected firms in every version of the model. In all cases the contrast is negative, indicating that connections lead to a slower rate of employment growth compared to unconnected firms. The estimated contrast between the growth rates of connected and unconnected firms is between -0.043 and -0.054. The latter estimate has the highest precision being significant at the 5% level. It is given by model 5, which estimates the interactions between connectedness and both sector and country, and also uses country dummies. In terms of actual employment growth, this model predicts that political connectedness reduces annual employment growth rate by 1.75 percentage points compared to non-connected firms.

Figure 2. Contrast of predictive margins of connected by country with 95% confidence intervals



Source: BEEPS VI survey, author's calculations, Note: AL=Albania, RS=Serbia, BA=Bosnia and Herzegovina, MK=North Macedonia, XK=Kosovo, SI=Slovenia, BG=Bulgaria, HR=Croatia, ME= Montenegro

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The impact of connectedness on employment growth differs across sectors. It has a significant impact in the services sector, reducing annual employment growth in that sector by 2.19 percentage points. However, there is no effect of connectedness on employment growth in the manufacturing sector. Political connectedness in the services sector has a distinctly negative impact on business performance, in sectors such as retail and wholesale, and in construction. Examples of the negative impact of political connectedness in the construction sector have been noted above in Serbian street lighting and in Kosovan road building activities. In addition, the notorious example from the retail sector, the Croatian firm Agrokor, illustrates the potentially disastrous effects of political connectedness in firms that are “too big to fail”. In that case, political connectedness facilitated a perilous business strategy of debt-fuelled over-expansion leading eventually to massive job loss (see also: Djuric & Jovanovic, 2019).

The contrasts of predictive margins for the interaction between the variables “country” and “connected” are significant at 1% level for Serbia (contrast=-0.203, $t=-2.72$) and at 5% level for North Macedonia (contrast = -0.216, $t = -2.31$) (see also Figure 2). This suggests that political connectedness is especially important factor in firm performance in these two countries. In Serbia, being politically connected has an adverse effect on firm performance equivalent to a 6.1 percentage point annual reduction in firm performance, proxied by employment growth, while in North Macedonia the effect is equivalent to a reduction in annual employment growth of 6.5 percentage points (see also Table 2). Large negative effects are also observed in Bosnia and Herzegovina, and Kosovo, but these effects are not statistically significant even at the 10% level. The only case in which the effect of political connectedness is positive, Albania, also does not pass the test of statistical significance. It is also apparent that political connectedness has no overall impact on firm performance in the EU members states in South East Europe: Slovenia, Bulgaria and Croatia, or in the most advanced candidate state Montenegro.

5. Conclusions

This paper has argued that the phenomenon often referred to as “state capture” in South East Europe can better be described as “business capture”. State capture, at least in its initial formulation, referred to a process by which large enterprises run by wealthy tycoons captured state institutions through means of bribery and corruption. This may have been a good characterisation of the situation in Russia following the breakup of the Soviet Union and the unruly process of privatisation that led to a massive accumulation of wealth by the new owners of large firms in the natural resources sector. However, in South East Europe, although there have been examples in which privatisation led to the emergence of wealthy tycoon capitalists, firms were never in a position to capture the state. Instead, ruling political elites have emerged in the form of powerful clientelistic political parties that dominate the state and seek to control the business sector through neopatrimonial networks. This process has been illustrated in this paper through a few examples from the emerging literature on state capture in the region, and from media reports of business capture in specific sectors such as construction and retail. In a few cases where large firms have become potentially more powerful than the state, the ruling parties have invariably stepped in to reassert their control. This has been illustrated by a couple of examples from Croatia and Serbia where powerful tycoons have faced arrest and confiscation of assets, although in neither case did legal procedures lead to serious convictions.

The concept of business capture relates to the idea of “influential firms” as opposed to “captor firms” identified in the classic article on state capture by Hellman et al. (2003). The idea of influential firms points to the way in which business capture is implemented through close ties between political actors and business firms, in particular through the appointment of politicians to company boards, or outright ownership of firms by politicians or members of their families. Such cases have been widely observed in many emerging economies and have been studied through the lens of the effect of firms’ political connections on business performance. Some researchers have argued that political connections enhance firms’ performance through privileged

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access to loans and state procurement contracts, while others have pointed out that political connections can lead to poor business and investment decisions, a wasteful use of scarce resources and damage firms' business performance as a result. In this sense, reducing or eliminating business capture should provide a boost to growth.

Much of the research on state/business capture, clientelism and associated democratic backsliding has been based on qualitative research and case study examples. In this paper, however, I have followed the empirical literature on the impact of political connections on business performance to develop and estimate a model of business capture in SEE. The results of the model show that in this region, on average, political connections have an overall negative impact on firm performance. This effect persists through a number of functional forms of the estimated model. The model also shows that the negative impact of political connections is especially severe in the services sectors of these economies, rather than in the manufacturing sectors. It also shows that the Western Balkan countries have been more adversely affected by business capture than have the EU member states in the region, with the most significant and notable negative effects of political connectedness occurring in North Macedonia and Serbia. Noticeable negative effects are also found in Bosnia and Herzegovina and in Kosovo, but the statistical significance of the impact in these two countries is weak, while a positive but non-significant effect is found in Albania.⁸

⁸ It should be noted that the empirical research reported in the paper leans heavily on the use of employment as a proxy indicator for business performance. This has some weaknesses, notably that employment levels of a firm are the result of a derived demand for sales and investment. In future research it would be useful to compare the results using different dependent variables. The main difficulty in relying on employment growth as a proxy for firm performance is the implicit assumption that all firms in each industry use the same technology, so that an increase in demand for the product(s) supplied by a firm is reflected in an increase in the firm's output and/or investment, which in turn implies an increase in the firm's demand for labour and hence in its employment level. There may be circumstances in which such an assumption is invalid, but for the purposes of this paper we put these concerns to one side. In future research such an assumption could be tested by using alternative indicators of firm performance such as profitability or market penetration indicators if reliable data on these variables could be obtained. While it might also be useful to test the robustness of the results over a longer time scale, the relatively short time span of three years does serve to bolster the

In sum, the paper has investigated the role state/business capture in SEE and identified that rather than states being captured by business interests, it is more often the case that the business sector is captured by the state through powerful neopatrimonial networks linked to clientelistic ruling parties. This process takes the form of political appointments to boards of private companies, or political officeholders (or members of their families) running firms as owners or managers. According to research into similar situations around the world, the effect of such political connections on business performance can be either positive or negative. The empirical analysis of political connections in this paper has shown that such political connections tend to have an adverse impact on business performance, especially in the services sector and in some of the countries of the Western Balkans. The policy implications are considerable. The focus on business capture and political connectedness suggests that public policy should emphasise support for non-connected firms, for example by supporting the entry of start-up firms. Public policy should also direct state support, and especially EU investment funds, to politically independent firms including both large independent firms and SMEs. This contrasts with the emphasis on introducing anti-corruption measures which have largely been ineffective and that have been the main focus of policy recommendations by those who see the problem as one of state capture rather than business capture.

Finally, the EU member states in SEE seem to be somewhat immune to the negative effects of political connectedness. While political connections persist in those countries, the more benign influences on business performance appear to offset the potential negative effects. Whether EU membership as such is responsible for this weakening of the more pernicious effects of business capture in those countries remains to be studied in future research.

use of employment growth as a proxy variable since it is less likely that major changes to technology would take place than over a longer period.

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