

2. DIMENSIONS OF POLITICAL ECONOMY

2.1 Defining the Concepts

The term **political economy** is subject to multiple understandings. Its origin can be found in the work of Adam Smith's *Wealth of Nations*, of David Ricardo and Karl Marx. In this body of work, the term referred to the *conditions of production organization in nation-states* or what today is understood as 'economics'. Today, the term is defined as ***analysis that studies the linkages between politics and economics***, drawing on theories of economics, law as well as political and social sciences. Economic theory traditionally focuses on market decisions, where voluntary exchange leads to Pareto efficient⁷ outcomes. The decisions that political economy focuses on are those where the market does not produce these desired outcomes — for example, in the case of over-exploitation of land/resources due to unclear tenure — as they are influenced by political and not economic considerations. Hence agreements on rules that govern the voluntary exchange are needed, such as property rights or crop rotation regulations. Different disciplines such as psychology, international relations, law or ecology have incorporated the meaning of political economy to study the interactions in their respective disciplines. Ecologists, for instance, think of ways to change market incentives to address environmental sustainability concerns.

The most common way of approaching political economy in development work tends to be from either an economic perspective using rational choice-based models, or from a political scientific perspective through power-based models. **This work is based on the power-based approach.** Since the power-based perspective is strongly linked with the economic models and a substantial number of development studies in political economy build on those, we will briefly outline the main analytical arguments to frame our discussion of the political economy of reform.

(a) The rational choice perspective on political economy

The rational choice approach leads economists to investigate the conditions under which rational individuals are willing to cooperate in collective action problems. This implies the analysis of *institutions*, defined here as *formal and informal rules underlying political powers, bureaucratic agencies or social and private organizations*. It also implies giving recommendations to improve institutions to guide individuals' behavior and exchanges so that they can still maximize their own benefit without harming other individuals and the environment⁸. The most important relevant streams of work in economics are: the theory of the development of institutions⁹, the agency theory of bureaucracy¹⁰, and rent seeking in public choice theory¹¹.

This perspective tends to inform the way that economists tackle political economy challenges such as the impacts of decentralization on power relations¹², public spending reforms in favor of powerful middle-classes at the expense of less-powerful groups¹³, institutions and growth¹⁴, principal-agent problems (e.g. in voucher

⁷ Pareto efficiency is achieved when resources are allocated to maximise benefits to all individuals, but without making any individuals worse off in the process.

⁸ Moe, 2005

⁹ e.g. North and Weingast, 1989; Buchanan, 1987

¹⁰ Niskanen, 1994

¹¹ Mueller, 2003

¹² Besley et al, 2005

¹³ Keefer and Khemani, 2005; Rudra, forthcoming

¹⁴ North, 1990; Rodrik 2004; Keefer and Knack, 1997; Keefer, 2004

systems for education¹⁵) and how rent-seeking of vested interests influences public investment, again in favor of some at the expense of others¹⁶.

(b) A power-based approach

Critics of the rational choice perspective on political economy raise the question how and especially by whom institutions are built and can be re-built. They question the capacity of this kind of political economy analysis to engage effectively with political dimensions of policy issues and thus to inform decision-making¹⁷. Critics argue that institutions are consistently created by powerful interests that favor the better-off, while “losers” remain in their original state or end up even worse-off, especially in countries with “weak” governments. Even an alternative approach built on Coase’s theorem¹⁸, they argue, does not solve the incentive problem. Under this approach inequalities in results of policy interventions are addressed through a bargaining process in which winners of policies have to compensate losers to arrive at a Pareto improving outcome. This assumption is questioned by critics such as Moe¹⁹, who argue that there remains little incentive for actual compensation since winners do not depend on the losers’ support to push a reform through.

The power-based model emphasizes that cooperation (as is assumed in rational choice models) does not always lead to beneficial outcomes for all. Instead, institutions might be persistently created in favor of powerful interests. Similarly, North²⁰ argues while the ‘right institutions’ may yield economic growth, rulers might often tend not to choose such institutions, but rather those that favor their own interests. Following this power-based view of political economy, some political scientists²¹ have argued that power is a missing perspective in the rational choice approach. They emphasize the potentially destructive nature that power can have and therefore suggest integrating ‘power’ into the rational choice perspective. Moe²² argues that this might require only a shift in perspectives and analytical adjustment, instead of a new theory of political economy.

2.2 Approach Taken

The power-based model forms the basis of the political economy of reform approach taken here. It draws upon economic, social and political theory in order to understand how political, economic and social actors, institutions and processes influence each other. This model in turn facilitates an analysis of how political economy factors constitute risks or opportunities for country-driven and country-owned change through development intervention. The approach will look at how actors use their position to protect or strengthen their political or economic interests. It can reveal the conditions and processes under which political actors or political entrepreneurs maneuver within institutional contexts to build coalitions, negotiate, build consensus, and bargain to generate new policies, new legislation, and new institutions.

Political economy analysis has been widely and increasingly applied to policy reform. Grindle and Thomas²³ for example, categorize policy reforms and define policies in terms of their costs and benefits. They ask: who wins, and how broadly or narrowly are those benefits distributed? Who loses and where are those losses concentrated? Secondly, they also stress the context of policy reform, asking: what is the impetus and motivation for reform and how do political interests, that surround reform decisions, play out? In more recent work supporting DFID’s ‘Drivers of Change’ initiative, Grindle²⁴ develops stakeholder and institutional assessment

¹⁵ Gauri and Vawda, 2003

¹⁶ Keefer and Knack, 2007

¹⁷ Frey, 1994

¹⁸ see Moe, 2005

¹⁹ Moe, 2005

²⁰ North, 1990

²¹ e.g. Bates, 1989; Levi 1988; Moe, 2005; Olson, 1993

²² Moe, 2005

²³ Grindle and Thomas, 1991

²⁴ Grindle, 1999

matrices to assess the interests of actors and the institutional context of policy reform. The analysis of stakeholders examines their priorities, motivation, resources, degree of influence, and actual and potential alliances. The analysis of institutions investigates the level of access that different actors have to the policy reform's institutional context, the "rules of the game" that operate in this context, the distribution of resources of power/influence, and the degree of importance of the institutional context to the outcome of the policy reform. Levi²⁵ examines the conditions under which citizens have the incentive to comply with, or disobey the demands of democratic governments. One of her main findings is that citizens tend to comply if their personal costs are not higher than the expected benefits and also, if they find the government trustworthy²⁶.

Theorists of policy reform are only too aware of the significance of context for determining policy reform progress and outcomes. Pierson and Myles²⁷ highlight the importance of existing policy arrangements as sources of incentives and constraints to change. Grindle and Thomas²⁸ suggest that the length of time needed to implement a reform also has an important influence on the reaction generated to it. Bonoli²⁹ finds that greater concentration of political and institutional power is more likely to incline governments to pursue radical policy reforms, while it also increases possibilities of electoral defeat and popular protest. In contrast, in situations where power is fragmented, governments are compelled to pursue reforms through negotiation and by providing what could be quite substantial 'quid pro quos'. In this way, reforms are more likely to be accepted, but they are likely to emerge with content that is considerably different to that originally envisaged.

In addition to a focus on institutions and actors, political economy analysis can also be applied to the *process* of policy management. Brinkerhoff and Crosby³⁰, for example, emphasize the significance of ownership and dialogue, which are important process factors that become central to the effective management of policy reform.

Beyond the management of political economy risks *to* successful policy reform, a political economy perspective can also be brought to bear on the political economy risks *of* policy reform to equity outcomes. It does so by assessing the likely impact of policy reforms related to institutions, actors and processes in any given instance on power relations and the distribution of benefits. Will the reform process centralize power and authority thus creating opportunities for elites to capture benefits in ways that were not anticipated? The institutional constraints to progressive changes in power relations can be mapped across economic, political and social spheres of life³¹. Economic constraints include rules that restrict access to markets, land, labor opportunities and credit. Legal constraints cover systems of property rights that favor specific social groups, or the persistence of corrupt or unequal practices by police and judiciary. Political constraints comprise less-than-democratic processes, such as clientelism, intimidation or censure that give rise to "thin" forms of democracy and deny poor people a political voice. Finally, social constraints include forms of inequality rooted in class, race, gender or patron-client relations.

2.3 Political Economy of Reform and PSIA

The conceptual framework for the political economy of sector reform presented in this paper builds on over six years of Poverty and Social Impact Analysis (PSIA) experience, where institutional, political and social analyses across several sectors and regions have been applied. The use of PSIA to examine changes in power relations is outlined in the World Bank Sourcebook of "Tools for Institutional, Political and Social Analysis of

²⁵ Levi, 1991

²⁶ See also Braithwaite and Levi, 1998

²⁷ In Pierson, 2001

²⁸ Grindle and Thomas, 1991

²⁹ In Pierson, 2001

³⁰ Brinkerhoff and Crosby, 2002

³¹ Alsop et al, 2006

Policy Reform'.³² PSIA can be used as one possible tool to analyze political economy issues³³, but not every PSIA has to automatically include a political economy analysis. A recent review shows the usefulness of PSIA in the agriculture sector to evaluating the influence of local level power relations on poverty and social outcomes (see Box 1). The conceptual framework for this study, introduced in Chapter 3 below, aims to build on this experience by providing a systematic framework for the incorporation of political economy issues into Poverty and Social Impact Analysis.

Box 1: PSIA and distributional equity in agricultural sector reform

A recent review of twenty three PSIA studies in the agriculture sector examined the contribution and experience of conducting social analysis as a part of multidisciplinary poverty and social impact analyses of agricultural reforms. The review found that efficiency and performance were the most common motivations for implementing agricultural reforms, although distributional impacts and equity concerns were also mentioned as significant drivers. Stakeholder analysis conducted for these PSIAs was effective in analyzing the social fault lines amongst rural communities of consumers and producers and unpacking the power relations between different interest groups. The stakeholder analysis helped identify likely winners and losers while broadening perceptions of who might have an interest or stake in reforms. The analysis revealed that much behavior under policy reform was based on capture and control of rents. Also, in many cases, the analysis gave better insight into the relationship between the political interests of elites and their influence on the reform proposal, showing how political forces could slow down the reform process. The PSIA process helped identify institutional weaknesses that could hamper successful implementation of a reform. A key concern of several PSIAs was the response of the private sector to the declining role of the state, particularly in agricultural marketing.

In the most effective cases, PSIAs both identified and helped the process of managing political economy risks by prompting changes in the design or timing of the proposed reforms. In particular, the early and inclusive involvement by the stakeholders with most at stake had a significant impact on design and ownership. The findings of this report suggest that the political economy of reform processes should be a major focus for social analysis methods and practice in the next generation of PSIAs.

Source: World Bank (2006e). "Stakeholder, Power relations and Policy Dialogue; Social Analysis in Agricultural Sector Poverty and Social Impact Analysis", Washington D.C., World Bank, November

2.4 Demand for the Analysis of Power Relations in Practice

In 2004, the Operations Evaluation Department (OED) of the World Bank hosted a Conference on the Effectiveness of Policies and Reforms³⁴. A key finding was that **reforms are never linear and that sustained reform is 'more like a marathon than a sprint in nature'**. This finding emphasized the process aspect of reforms. In a process, selectivity, timing, and sequencing matter a great deal. The conference also confirmed the intuitive insight that home-grown reforms have a greater chance of success than externally imposed ones. One key recommendation that holds for all development partners, was to be patient, as reforms may take longer than planned and often run into unexpected obstacles. Development partners should persuade rather than prescribe, pay more attention to social and environmental impacts and negative impact mitigation measures, carry out better risk analysis and management, and should encourage ownership. In 2005 the World Bank's Operations Evaluation Department evaluated the Bank's development effectiveness³⁵. The evaluation found that even the best technocratic designs can wither in infertile political soil and therefore that development partners need to pay much more attention to the political economy involved in their work. The political risks, costs, and benefits, as well as the economic implications of proposed reforms must be assessed. Cus-

³² The other PSIA 'transmission channels' are employment, prices, access, assets and transfers and taxes (see Holland, 2007)

³³ Others, for instance are, SIDA's Power Analysis, DFID's Drivers of Change, the German Development Corporation's institutional and capacity development approach, and the World Bank approaches to political (economy) analysis in regard to growth, governance, and equitable and sustainable development through its Institutional and Governance Reviews (IGRs), Country Governance Assessment Processes (CGAP) or Country Social Analysis (CSA).

³⁴ Conference on the Effectiveness of Policies and Reforms. World Bank Headquarters, Washington DC. World Bank Operations Evaluation Department, 2005

³⁵ World Bank, 2005b

tom-fitting reform interventions to the political economy are as important as custom-fitting reforms to the real economy:

*“Reforms work if you have a good sense of who the winners and the losers are, and if you have a good platform for dealing with the negative impacts of policy changes [...]. Economists like to look at the net welfare gain in societies, whereas politics is about winners and losers.”*³⁶

The political economy work presented here complements an increasingly important agenda within international development debates on good governance³⁷. Within the World Bank country-level Governance and Anti-Corruption work, encompassing both national and sector institutions, is a key part of this. Policy discussions are geared to promoting and monitoring institutions that enforce good governance, for instance strengthening sectors to promote accountability and probity through citizen empowerment. The political economy approach presented here — by systematically combining an operational approach towards equity with power-based models of change — incorporates governance concerns into an understanding of how to promote pro poor policy reforms.

³⁶ Danny Leipziger, speaking at the PREM Knowledge and Learning Forum 2007: How to Reconcile Economics and Politics², World Bank, Washington DC, April 16, 2007

³⁷ see e.g. World Bank, 2007a; 2008a