

Using Political Economy Analysis to improve EU Development Effectiveness

A DEVCO Concept Paper

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Section 1: Introduction

1.1 Purpose of the paper

European Commission staff, especially staff based in Delegations, are well aware that politics play a crucial role in shaping development outcomes. They increasingly recognise that the failure to take adequate account of this has led to mistakes and waste in development cooperation. Political economy analysis can help give them a clearer understanding of the political and economic processes at work in a given country or sector context, and how they influence institutional capacity and policy choices. This can help make development cooperation more effective.

This concept paper has been prepared as part of a broader DEVCO exercise to bring together existing guidance on development practice into one harmonised document, the *Project and Programme Cycle Management (PPCM) Guidance*. The concept paper explains what is meant by political economy analysis, why it matters fundamentally for understanding development challenges and outcomes, and the implications for donors. It also offers practical guidance on how to undertake political economy analysis at country and sector level, and suggests how to draw on the analysis to inform every aspect of EU development activity, including programming, identification and formulation of specific interventions, risk management and policy dialogue.

1.2 Overview of the sections

Section 2 explains the ***key concepts underpinning political economy analysis***. This theoretical perspective matters because the most important contribution that political economy analysis can make to increasing aid effectiveness is to help donors think more clearly about how development happens, and about the local processes with which they are engaging when they give development assistance.

Section 3 explains ***why political economy analysis is needed*** and how it poses new challenges and opportunities for development practice.

Section 4 looks at ***how to draw on analysis in making operational choices*** at country and sector level, based on the practical experience of EU Delegations and other donors; and how it can help inform risk assessment and policy dialogue.

Section 5 explains ***the range of political economy analysis tools available***, and introduces two approaches that can be used to undertake analysis at country and sector level. Detailed guidance is given in the annexes.

Section 6 covers ***practical aspects of undertaking political economy analysis*** including timing, resource requirements, sources and research methods and advice on managing the process. It also suggests next steps needed to build ownership for political economy analysis within the Commission.

Section 2: What is political economy analysis?

2.1 A definition

Political economy analysis investigates how political and economic processes interact in a given society, and support or impede the ability to solve development problems that require collective action¹. It takes particular account of the interests and incentives driving the behaviour of different groups and individuals, the distribution of power and wealth between them, and how these relationships are created, sustained and transformed over time. These relationships are crucial in explaining how politics works, how wealth is created, and how developmental change happens.

2.2 Reviewing key political economy concepts

The term “political economy” covers a broad set of intellectual traditions, with a long history. Different approaches have been designed from different ideological perspectives, and with different kinds of collective action challenges in mind. The approach taken in this paper is geared to the situation of many developing countries where informal relations and institutions play a major role². It draws on insights from research that highlight the centrality of institutions to economic growth and development, and the role of politics in driving institutional change. There is still considerable debate about what kind of institutions and policies best support development in the short to medium term, and patchy evidence about how effective institutions emerge and work in different contexts (Booth (2011a), IPPG 2010), However there is an emerging consensus that effective, accountable formal institutions capable of supporting a broad range of public goods evolve through complex, informal interaction between state and society, public and private actors, and formal and informal processes. The political economy approach presented below is based on some key concepts that command broad support among political scientists, and increasingly among development practitioners.

2.2.1 Organising collective action

Development depends on solving collective action problems, which requires different interest groups to find ways of cooperating to produce positive sum outcomes, and deliver broad public benefits. These include key public goods, such as protection from external threats; security for persons and property; peaceful resolution of conflict and competition for political power; measures to promote productive investment and economic growth; and provision of basic services. Conversely, the absence of development can often be explained by the failure of interest groups to cooperate around common goals.

¹ Collective action means the pursuit of a common goal by more than one person

² By contrast, approaches based on “principal-agent” frameworks may be more appropriate in contexts where there are clearer, formal relationships and institutions of accountability – for example between policymakers, service providers and citizen consumers.

In societies based on small kinship groups, collective action can be organised informally, through face-to-face contacts and personal relationships of trust. A key development challenge is how to organise collective action in much larger, more complex societies where more specialised, impersonal arrangements are needed³. Crucially this requires the creation of some form of overarching political authority, with the legitimacy and coercive capacity to make and enforce collective decisions.

2.2.2 State-society bargaining underpins effective collective action.

Historical experience and contemporary research provide evidence for **how effective collective action emerges**. They point to the central role played by bargaining among different social groups, and between social groups and the state⁴. Such bargaining can involve violent conflict, but it can also take more peaceful forms, including contestation and negotiation over access to power and resources, and over ideas. Bargaining can take place at different levels of society, and through formal or informal processes. It can produce positive sum outcomes if the parties concerned can identify common interests and negotiate arrangements to pursue them. Over time this can lead to more peaceful ways of managing competing interests, and result in the creation of stable, legitimate institutions: arrangements which are valued – and thus become "institutionalised" – because they are seen to serve a common purpose. Conversely, a major part of the explanation for fragile states and persistent conflict in many poor countries is the absence of incentives for constructive state-society bargaining⁵.

An example of constructive bargaining is the negotiation of a basic "political settlement"⁶ or underlying compact whereby powerful actors agree to accept a legitimate coercive role for the state in exchange for common security. Another is state-society bargaining over taxation, which historically has been central to creating more effective states that are also accountable and responsive to citizens (box 1). Yet another is bargaining between political and economic elites which is central to economic growth and political development (box 2).

³ For an excellent, short account see Blake (2000). For a more detailed investigation, see North et al (2009).

⁴ Or, in very fragile states, between social groups and holders of political and military power.

⁵ See for example Centre for the Future State (2010), chapter 2.

⁶ The term "political settlement" is commonly used to describe the informal power relations in a country, usually between a coalition of powerful elite factions. A political settlement is held together by the alignment of interests within the dominant coalition, and the dynamic relation between elite interests and the broader array of interests within a society. See Parks et al(2010).

Box 1: State-Society Bargaining Over Taxation.

Historically in Western Europe, rulers needed revenue, notably to fight interstate wars. They therefore had strong incentives to nurture broad-based economic growth, and to develop effective bureaucracies to assess, collect and manage tax revenues (thus increasing state capacity). This prompted some citizens to organise to resist and negotiate tax demands, and press for more say in the way state revenue was used (thus increasing accountability). Bargaining over tax led over time to the creation of a social contract whereby citizens complied with tax demands in return for less arbitrary taxation, more influence over public policy, and more scrutiny by the legislature over public finances. A problem in many poor countries is that rulers have access to natural resource revenues or other non-tax sources of income, and therefore have few incentives to bargain with taxpayers or to nurture economic growth. Governance suffers as a result.

Based on Moore (2007).

Box 2: Bargaining between politicians and private investors

Relationships between people who hold political/military power and those who hold economic power are central to the creation of effective political authority and productive economic investment. Politicians need private capital to provide state revenue, finance political parties and make investments that secure public support. Investors need effective public authority to provide security, physical and financial infrastructure, and credible assurances that they will be able to retain the profits from their investments. Both parties therefore stand to benefit from cooperation. However in poor countries these relationships are often fraught and competitive. Politicians are tempted to predate on private capital (for example by confiscating assets or extracting protection money). Holders of capital may use their economic power to organise violent opposition or force politicians to give them exclusive benefits through monopolies and restrictions on competition. Both political and economic actors may lack organisational capacity, which makes productive cooperation more difficult. The results can often be "crony" arrangements that provide exclusive benefits to small numbers of powerful people, blocking broader economic growth and eroding public revenues through corruption.

Based on Moore and Schmitz (2008).

2.2.3 Elite incentives matter⁷

Elites, by definition, play a crucial role in these bargaining processes, and in solving (or failing to solve) collective action problems. Elites are people who have high levels of political,

⁷ Clearly elite interests are not the only ones that matter, but they are very influential, and tend to be neglected by donors.

military, bureaucratic, financial and economic power – either formally (as businessmen, politicians or religious leaders) or informally (for example as warlords or leaders of criminal gangs). Political economy analysis is therefore particularly concerned with how a country or sector context shapes the interests, incentives and capacity of political and economic elites. Deeply embedded social, economic and political structures, sources of revenue, and the global and regional environment are all important in influencing whether elites have incentives to nurture economic growth and create public goods, or to pursue narrow interests of self-enrichment. For the ruling political elite, a principal consideration will be what they must do to win and retain power. However, more intangible factors such as ideas, values, ideology and reputation can also influence elite incentives. In fragile situations, extreme fragmentation of elite interests can undermine collective action.

2.2.4 Explaining institutions

As noted above, arrangements that are seen to be effective in supporting collective action can become "institutionalised" over time; some are formally codified as written rules and procedures, but others depend on more informal relationships and social norms¹ Informal institutions are understood as "socially shared rules, usually unwritten, that are created, communicated and enforced outside officially sanctioned channels". (Helmke and Levitsky, 2004). In poor countries with weak formal institutions, collective action is often organised informally. This can be productive, for example when relationships of trust between business people help enforce contracts in the absence of more formal, legal arrangements; or when village level organisations undertake dispute resolution. But, informality can also lead to "crony" relationships that create exclusive benefits for a small number of powerful people, and undermine development. Political economy analysis is concerned with understanding the complex mix of formal and informal institutions that shape the behaviour of groups and individuals, and relationships between them. For example, competition for political power often takes place within a formal legal framework, but winning depends on delivering exclusive patronage benefits (jobs, money, access to services, monopoly privileges) directly to supporters or "clients", or appealing to ethnic or other sources of identity. Patronage may play an important role in maintaining political stability and social cohesion, but it can also undermine productive investment. Understanding the impact of these institutional arrangements in a given context is therefore critically important.

2.2.5 The role of leadership

While context and institutions are hugely important in shaping interests and incentives of different groups and individuals, leadership or the deliberate exercise of human agency also matters. Research⁸ is reminding development policymakers of the critical role played by leaders at both national and local level, and across all sections of society, in mobilising people and resources in pursuit of shared and negotiated goals. Leaders can promote development by forming coalitions to pursue institutional and policy reform, or can adopt policies that destroy institutions or obstruct reform. . Even in difficult situations where the political context and institutional structures act as a barrier to development, good leaders

⁸ See for example The Developmental Leadership Program, www.dlprog.org.

may be able to find ways of making progress by skilful political strategising (Grindle 2004). Donors may have little or no influence on how individual leaders emerge, but need to understand the political processes involved in exercising leadership, and may be able to play a role in facilitating them.

2.2.6 Creating conditions for constructive state-society bargaining

Political economy analysis is also concerned with how a wide range of interest groups can gain incentives and opportunities to organise and engage effectively in shaping public policy. An important underlying issue, particularly in fragile situations, is whether there is a sense of "political community" that gives different interest groups a sense of belonging together. Social networks play an important role in facilitating collective action. In addition, public policy, and the processes by which it is formulated and implemented, can also create conditions for constructive state-society engagement. Non-state actors need incentives to organise in ways that aggregate disparate interests and channel coherent demands, in order for politicians and public officials to be able to respond effectively⁹. How politicians and public servants behave, and how public programmes are designed, will influence whether non-state actors have incentives to organise around demands for broader public goods, or whether they think more will be gained by using personal networks to lobby for exclusive benefits¹⁰.

2.3 Linking political economy concepts to analysis

A number of analytical tools are already available to help donors investigate how political economy processes are playing out in a particular context, and how they are influencing development outcomes¹¹. Section 5 below and annexes 1 and 2 of this paper present two analytical frameworks that have been developed for the European Commission to explore the impact of political economy factors at country and sector level. They include a list of structured questions that are informed by the political economy concepts outlined in section 2.2 above, and are organised around three broad headings, as follows:

- "Foundational factors" that fundamentally shape the social, political and institutional landscape, and therefore influence the scope for constructive state-society bargaining, and the institutional arrangements for organising collective action. Foundational factors include the history of state formation, sources of public revenue, embedded social and economic structures as well as a country's geography and geo-strategic position.
- "Rules of the game" or the formal and informal institutions that shape the incentives and capacity of key actors, the relationships between them, and how processes of political bargaining play out. These are critical in influencing opportunities for

⁹ By non-state actors we understand a broad range of civil (as opposed to "uncivil") society groups, including religious, trade and professional associations, and the private sector.

¹⁰ See Centre for the Future State (2005).

¹¹ For details see section 5 below.

different groups, including those representing poor people, to mobilise and engage in collective action that promotes development.

- the "Here and now" that examines the conduct of day-to-day politics, and the way this is shaped by rules of the game as well as more contingent "events" ..

This structure helps the analyst assess opportunities for change by distinguishing between foundational factors that are often very slow to change, rules of the game which may be sticky but more susceptible to change over the medium term, and short term factors that may offer windows of opportunity for change.. It also provides the basis for assessing what is driving elite interests; what is shaping relations between politicians and investors, and how they might be more productive; what might stimulate collective action by social groups to demand better services; and how informal local institutions are influencing development outcomes.

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Section 3: Why do donors need political economy analysis? What does this mean for development practice?

3.1 Introduction

Donor agencies are under increasing pressure to show positive results and demonstrate value for money. At the same time, academic research and practical experience tell them that development has to be locally "owned"¹², and that the policies and institutions required for development have to be negotiated through local political processes. So donors need to make use of political economy analysis because **failure to take sufficient account of politics leads to poor development outcomes, and significant risks of doing harm**. In more positive terms, better understanding of political economy puts donors in a stronger position to promote lasting development through locally owned processes of change.

3.2 Evidence from evaluations and research

Research and evaluation of donor interventions over the past decade have shown the limitations of approaches that rely primarily on meeting financing and skills gaps, or encouraging the adoption of best practice¹³ policies and institutions. They also highlight problems with aid conditionality, and with supply-driven approaches that set over-ambitious goals in relation to local political and administrative capacity (Pritchett et al 2010). Evaluations of "good governance" interventions show the limited success of efforts to transfer formal institutional models from OECD countries into very different social and political contexts¹⁴.

Research is also highlighting the **important role played by informal institutions**. For example in China, very informal relations between investors and local government officials supported economic growth in the absence of more formal, legal protection of property rights (Qian 2003). Experience in fragile states is highlighting the critical role often played by informal, local institutions in providing security, resolving disputes, supporting livelihoods and providing links to more formal, public institutions¹⁵.

Ill-informed donor interventions can inadvertently do harm. For example, research into local level service delivery in sub Saharan Africa is revealing the damage done by frequent changes in donor policy prescriptions, and by incoherent, incomplete institutional reform (Booth 2011b). Warnings that donors should aim to "do no harm" are especially relevant in fragile states where the creation of parallel administrative structures and ill-timed pressure for elections can undermine state building processes (Putzel 2010). Researchers are also

¹² This is reflected in the Paris Declaration, which stresses the importance of local "ownership": however it fails to investigate whose ownership matters, or how it can be negotiated and sustained.

¹³ By "best practice" we mean the assumption that policies and institutions that have worked well in one setting (typically OECD countries) have universal value and will produce similar outcomes in other contexts.

¹⁴ See, for example, World Bank (2008).

¹⁵ See OECD (2010).

emphasising the need to judge the impact of aid not just by looking at direct, short-term results but also at its longer-term, cumulative impact: for example the potentially negative impact of aid conditionality and aid dependency on local accountability (Glennie 2008). Both research and practice are raising concerns that donor support for civil society organisations can distort and depoliticise agendas, and undermine incentives to create a membership base¹⁶. Research is also questioning the assumption that "all good things go together" in the sense that democracy, human rights, poverty reduction and growth can all be pursued simultaneously and will be mutually reinforcing (Booth 2011a).

All this means that **donors need a much better understanding of the context and political economy dynamics with which they are engaging**, and the likely impact of their interventions on local capacity to solve collective action problems. That is why an increasing number of donors (including DFID, Sida, the Netherlands Ministry of Foreign Affairs, the World Bank, NORAD and UNDP) are developing tools for political economy analysis. Section 5 below reviews these tools in more detail.

3.3 New challenges and opportunities for donors

Recognising that development is primarily locally driven has some very challenging implications for donors, but also offers new opportunities. Challenges include:

- **Responding to diversity and complexity.** Development challenges are often very context specific, and require micro level research to identify local political economy dynamics, and specific bottlenecks and possible solutions that are relevant to that particular context. This means development agencies may need to invest a lot of time and effort to understand informal institutions and relationships in each locality in which they are working, as findings from one locality may not have much utility in a neighbouring context. One way of responding to this is to do more to empower local actors who already have a good understanding of local context (see below).
- **Managing tensions between normative values and political feasibility.** Political economy analysis highlights the tensions that can arise between the values and objectives of donors, and the need to build on locally rooted institutions and engage with the interests of politically powerful actors. Donors need to retain their long-term vision of promoting poverty reduction, democracy and human rights, while being more open to informal, unorthodox, incremental ways of making progress in the short- to medium-term. They need to start with where a country is, rather than with a specific reform agenda; think about the function rather than the form of institutions; and look at the actual impact of informal institutions in a given context rather than assessing them against an ideal standard¹⁷. They need to prioritise the interests of poor and vulnerable people, but recognise the role played by more powerful people

¹⁶ See Bano (2008) and Booth (2011b).

¹⁷ This approach has been described as 'best fit' rather than 'best practice' – see Levy, B (2010), "Feasible policy: Beginning with things as they actually are", World Bank Blog <http://blogs.worldbank.org/governance/feasible-policy-beginning-with-things-as-they-actually-are>

whose influence is crucial in state-society bargaining. Political economy analysis offers no easy solutions to such dilemmas, but it does provide a basis for thinking about them more clearly, and therefore managing them more effectively.

- **Managing expectations of EU taxpayers.** There are clear tensions between the desire of EU taxpayers to see rapid, positive results from development assistance, and the reality that long-term and durable results depend on supporting locally 'owned' political processes that are likely to be messy, non-linear, and incremental. Political economy analysis points to the need for a more sophisticated, open debate in donor countries about the risks, challenges and compromises inherent in providing development assistance, including risks relating to corruption.
- **A different role for donors.** As external actors engaging with local political processes, donors can expect to play only a modest role, operating as conveners and facilitators of change processes rather than as primary drivers of development. Experience suggests they may have limited leverage even in aid dependent countries, and many countries are becoming less aid dependent¹⁸. Large amounts of financial aid will not necessarily have a transformative effect, and aid cannot be traded for broad commitments to improve governance. Donors often have valuable technical knowledge to offer, but they need to deploy this in more politically intelligent ways. All this raises the question of whether development agencies have the right mix of skills and policy instruments. This is pursued in section 6 below.

In short, it may be much harder than is often supposed to use aid directly to influence behaviour or support effective collective action. However, there may be **opportunities** to help shift incentives and facilitate constructive bargaining over the longer-term, especially if donors use aid in combination with other sources of influence. These could include:

- **Empowering local policymakers,** who often have detailed knowledge and legitimacy that donors lack - for example, by financing good quality research to inform local decision making. They could also adopt more politically sensitive approaches in disseminating research findings and advocating policy reform; and provide more support for local policy analysis and data collection. They could often do more to use their convening power to stimulate better informed and inclusive public debate, and pay more attention to how they frame development narratives.
- **Seeking greater coherence** between development, diplomatic, trade and security objectives. Trade relations, and the behaviour of EU governments and businesses, influence the incentives facing politicians and business people in partner countries. Useful initiatives include efforts to increase the transparency of natural resource revenues through the Extractive Industries Transparency Initiative; improvements in

¹⁸ This may reflect growth in GDP rather than net falls in aid inflows.

global financial regulation to reduce the scope for money laundering¹⁹; and the EU FLEGT Action Plan (see box 3 below).

- **Engaging with a broader range of partners and interests.** Political economy analysis highlights the importance of identifying and building on common interests between different stakeholders. For example, professional associations, trade unions and business people often have interests in better infrastructure, and improved regulation, that can overlap with development objectives. Donors need to look beyond their usual partners and frame their narratives about development in ways that resonate with this wider audience.
- **Thinking about the indirect impacts of aid modalities and programme design** on incentives for collective action. For example, more transparent, predictable aid channelled through government systems could help strengthen bureaucratic incentives to improve planning and budgeting systems, and encourage the engagement of non-state actors. Specific project or programme interventions can be designed deliberately to encourage the participation of user groups and other key stakeholders.

Box 3: A political economy approach to forest governance: The FLEGT Action Plan

The EU **Forest Law Enforcement, Governance and Trade** (FLEGT) Action Plan is a good example of a political economy approach that empowers local actors, builds on coherence between development, commercial and environmental objectives, brings together government, business and civil society partners, and uses aid and good project design to help change local political economy dynamics.. Under FLEGT the EU enters into voluntary partnership agreements with timber producing countries, based on local negotiation to decide what constitutes “legality”, and to agree effective arrangements to certify that exported timber comes from legal sources. The approach:

Uses **EU market power** to incentivise governments and businesses in timber producing countries to tackle illegal logging.

Builds on **common interests** between business, government and civil society actors (fear of losing market access, jobs, revenue, forest user rights; and reputation).

Employs **skilful design** of multi-stakeholder processes to empower local civil society actors, and combine local flexibility with adherence to EU principles.

Makes **strategic use of aid** to provide long-term, targeted, flexible support.

Evidence from Ghana and elsewhere suggests that this could be much more effective than conventional approaches to improving forest governance. In particular, the process of negotiating voluntary partnership agreements appears to have improved understanding between government, business and civil society actors, allowed them to identify shared interests in tackling illegal logging, and strengthened their capacity to take collective action.

¹⁹ See [ref to International Drivers paper]

Section 4: Adding value through political economy analysis.4.1

4.1 Introduction

There are many examples of how political economy analysis has led to operationally useful findings²⁰. However, it is also important to have realistic expectations about what such analysis can and cannot offer. Political economy analysis is unlikely to suggest a completely new menu of policy options²¹. EU Delegation staff will probably already be aware of many of the issues raised by the analysis. But analysis can help staff understand the significance of their existing knowledge, and to articulate and legitimise it in ways that makes it useful for decision-making. Political economy analysis can be particularly helpful in ensuring that EU Delegations draw fully on the experience and understanding of their local staff. It can also help preserve and build on the institutional memory of Delegations, and can provide good induction material for new staff.

The following sections provide examples of how using political economy analysis can add value at various stages of the project and programme cycle, including country programming, programme and project design, policy dialogue, and risk management.. It draws on the experience of other donors, and also country and sector level analysis in Zambia conducted in June 2011, using the analytical frameworks presented in this concept paper.

4.2 Expanding understanding of the country context

Country level political economy analysis provides vital information on the broad challenges that will need to be addressed through EU funded projects and programmes. Specifically, it can help to identify:

- **Underlying causes of conflict and fragility.** Political economy analysis²² is particularly important in fragile situations where donors risk making things worse if they fail to understand actual or latent causes of instability.
- **Basic characteristics of the state.** Country level analysis can highlight "foundational factors" that have a pervasive influence on politics and development. They may be very hard to address, but if opportunities arise they deserve priority. Examples include oil in Nigeria, social exclusion in Nepal, ethnic cleavages in Guyana, or the history of land settlement in Zimbabwe. Country level analysis can also highlight the political salience of development issues – for example water in Yemen and Pakistan.
- How the **international and regional context** affects politics and development, including security, investment and changing business competition.

²⁰ See Duncan and Williams (2010)

²¹ A workshop with EUD staff in Lusaka in June 2011, which discussed a country level political economy analysis for Zambia, noted that this did not indicate doing very different things, but it did point to the need to do a lot of things differently.

²² As explained in section 5 below, political economy analysis can usefully be supplemented with other tools for analysing conflict or underlying political settlements.

- **Socio-economic trends** that have the potential to change political economy dynamics in the **medium term**, including improvements in education and communications, and demographic change.
- **The political feasibility of change**, including patterns of behaviour and policy-making that either support development or help explain persistent failures to address policy and institutional constraints. These factors are likely to affect performance across a range of sectors.

DFID has been using "Drivers of Change" analysis for many years to inform country strategy development. For example, it has prompted them fundamentally to reshape programmes in **Nigeria and Nepal**.

Box 4: How DFID used political economy analysis for strategy development in Nigeria and Nepal.

DFID's drivers of change studies in Nigeria highlighted the fundamental importance of oil revenues in shaping development outcomes and led to a critical reappraisal of how a medium sized donor could achieve influence in the context of low aid dependency, deeply dysfunctional public institutions and unmet public expectations. A change of approach emphasised the importance of strengthening sources of demand for greater public accountability, and focusing DFID support on selected issues where political economy analysis pointed to greater feasibility of reform.

In Nepal a strategic conflict assessment in 2002 suggested that donors were inadvertently channelling aid in ways that deepened social exclusion, thereby contributing to the continuation of conflict. A major reorientation of programmes included working with the government where it had some will and capacity, while also supporting parallel mechanisms such as micro-level community development. Following the end of the civil war, political economy analysis focused on new sources of regional conflict; the political economy of growth; and the role of trade unions. Taken together, these political economy studies have helped DFID think through how they can most effectively support an emerging political settlement, economic development and state building without reigniting conflict. *Based on DFID (2009).*

Box 5: Using political economy analysis to find the room for manoeuvre in Zambia

The European Commission and the EU Delegation in Lusaka commissioned **country level political economy analysis in Zambia** against the background that donor leverage is reducing as Zambia becomes less aid dependent, and has access to alternative sources of finance including semi-concessional loans from China. While Zambia is a peaceful, democratic state in what has been a turbulent neighbourhood, it has proved consistently hard to get political support for a well-defined set of policy and institutional reforms that have the potential to unlock economic growth and poverty reduction. The country level analysis investigated the underlying reasons for this, and the scope for finding some political room for manoeuvre in the short term, while looking for ways of shifting the interests and incentives of influential policymakers in the medium term. A workshop discussion with other donors identified the following options:

Find a more compelling political narrative, placing less exclusive emphasis on things that are wrong and need fixing, and more on missed opportunities for Zambia to regain middle income status and regional influence.

Recognise that **effective dialogue** depends on how Zambian partners view the interests and legitimacy of EU interlocutors, and be more aware of this (for example perceptions of double standards in relation to agricultural subsidies).

Look for politically feasible policy options: for example the World Bank has been advocating electricity tariff increases linked to improving performance of the key parastatal (Zesco) rather than pushing for outright privatisation.

Adopt more politically informed strategies for disseminating research messages to targeted audiences, and advocating for policy reform.

Consider opportunities to support **more equitable, transparent, predictable tax regimes**, building on common interests between government, business, civil society groups and tax officials.

Maximise the scope for international and EU leverage through global initiatives such as the EITI and other multi-stakeholder processes.

Finance good quality, micro level research to support Zambian policymakers in improving local service delivery.

Make the case for **more expert staff** based in Delegations and country offices for effective professional engagement with Zambian counterparts.

4.3 Country Programming

Country and sector level political economy analysis can help with making strategic choices about programming, including choice of focal sectors. For example, it can highlight sectors where there are particularly sensitive political interests at stake which may obstruct progress; or significant opportunities for rent seeking which impose corruption risks. It can help identify politically feasible strategies for progress in the short to medium term, and scope to build on common interests in reform over the longer term. These assessments are critical to decisions about financial allocations and envelopes to sectors. They do not necessarily imply that the EU Delegation should avoid working in sectors or sub-sectors where it is difficult to make progress, but they will help in setting realistic objectives and timeframes, and therefore financial allocations.

4.4 Programme design

Political economy analysis can help inform decisions about how financial aid is channelled and how programmes are designed by identifying their likely indirect impact on local incentives for productive bargaining. Political economy analysis can also prove valuable at the identification and formulation stage of the programme cycle in order to address specific questions about the design and implementation modalities of new EC projects and programmes. It can help to identify particular entry points for EC support, test the validity of the proposed programme approach and logframe, and address questions about implementation modalities.

4.5 Policy dialogue

Political economy analysis can **inform policy dialogue** about overall development challenges and outcomes, and may also contribute to framing broader **political dialogue**. The analysis can offer important insights into the values, interests, and perspectives of development partners. It is especially important in trying to frame a more politically compelling development narrative: i.e. one that engages with the incentives of key policymakers and politicians. For example, in Zambia EU Delegation staff and member states noted that dialogue with government about development issues was mostly formal and focused on problems arising from management of budget support. While necessary, this tended to crowd out more informal discussion, and deflected attention from developing alternative narratives – for example based on Zambia's potential to unlock economic growth and regain middle income status.

4.6 Public financial management and macroeconomic management

Insights gained from political economy analysis can help deepen assessments of public financial management and macroeconomic management, and so contribute to decisions about aid modalities. Country level analysis can help explain the political logic underlying decisions about revenue raising and public expenditure management, for example pinpointing reasons for widespread tax evasion, or political interference in budget processes, and divergence between formal budgets and actual expenditure. It can also help explain

broad patterns of resource allocation between sectors and between national and subnational levels of government, and the effectiveness of the audit function or tax authority. Political economy analysis can deepen macroeconomic assessments by explaining why politicians may have few incentives to nurture economic growth or increase domestic revenue raising. The analytical tool designed for sector level analysis could be adopted to ask more detailed questions about the key relationships in play – for example between politicians and businessmen, or between the Ministry of Finance and other ministries.

4.7 Risk Management

Any aid intervention involves interacting with a complex set of local political and institutional dynamics at country and sector level. Political economy analysis is therefore central to risk assessment and management, including unpacking risks arising from "lack of political will" and lack of political or institutional capacity to sustain programme and project benefits over time. Political economy analysis at both country and sector level can deepen understanding of risks arising from corruption, and from other factors that can lead to the misuse or ineffective use of aid funds, including weak financial and macro-economic management, and the distortion of programme or project objectives by powerful actors for personal gain. It also signals the need to consider risks arising from the indirect impact of aid interventions. For example, local political economy dynamics will be changed by the arrival of an external player, especially one bringing significant financial and other resources. Different aid modalities and institutional arrangements will have variable, indirect effects on local budgeting and administrative systems which political economy analysis can help identify.

4.8 Capacity development

Capacity has been defined as the “ability of people, organisations and society as a whole to manage their affairs successfully”²³ - in other words, to organise effective collective action. Political economy analysis reinforces the message that building capacity involves locally negotiated, political processes, although these are often shaped by external factors. Political economy analysis can help with understanding the wider political and institutional context that shapes opportunities and incentives for capacity development within formal organisations, and the “political dimension” of informal relationships and practices within them. It also highlights the need to take account of existing informal institutions that may be supporting effective collective action, albeit in unorthodox ways, and cautions against unintentionally undermining them by introducing new procedures or empowering new players. Finally, political economy analysis underlines the need to consider the long-term, cumulative impact of aid and aid conditionality on local capacity and incentives for solving collective action problems – especially in fragile situations and aid dependent countries.

²³ See Europe Aid (2009) *Toolkit for Capacity Development*, Tools and Methods series, reference document 6.

Section 5 - Tools for political economy analysis

5.1 Existing tools

There is no single method for conducting political economy analysis. A broad range of frameworks and tools are available giving the analyst considerable choice in deciding which approach best fits the problem at hand. An increasing number of bilateral and multilateral donors have developed and applied tools for political economy analysis. They include DFID (Drivers of Change), the Netherlands (Strategic Governance and Corruption Assessments), SIDA (Power Analysis) and the World Bank (Problem-driven Governance and Political Economy Analysis). While different donors have developed different tools, they have learned from each other, and there is broad compatibility between the different approaches. Their common focus is to analyse the underlying factors shaping the political economy and the resulting incentives, with a view to explaining the varying development performance of different countries and sectors, and predicting where aid can be used most effectively.

The existing tools can be grouped into three main categories: country level analysis, sectoral analysis and problem focussed analysis. Examples of these tools and an explanation of their uses are provided in the table below:

Level of analysis	Existing tools	Main uses
Country level analysis	DFID Drivers of Change ²⁴ Netherlands Strategic Governance and Corruption Assessment ²⁵ SIDA Power Analysis ²⁶ UNDP Political Analysis and Prospective Scenarios Project (PAPEP) ²⁷ Asia Foundation Political	Provides a broad overview of the country context, its economy and political system, and opportunities and constraints for change. Helps to assess the potential for development agencies to promote change, and how they can best use their influence. Useful for informing the design of more realistic country strategies and programming, including risk assessment.

²⁴ See Drivers of Change, Public Information Note', DFID, 2004. <http://www.gsdrc.org/docs/open/DOC59.pdf> and GSDRC Topic Guide on Drivers of Change <http://www.gsdrc.org/go/topic-guides/drivers-of-change>

²⁵ See 'Framework for Strategic Governance and Corruption Analysis (SGACA): Designing strategic responses towards good governance', Unsworth, S. and Conflict Research Institute (CRU) (2008). Prepared by the Clingendael Institute for the Netherlands Ministry of Foreign Affairs.

²⁶ See 'Power analysis – experience and challenges,' concept Note, SIDA, June 2006. http://www.sida.se/sida/jsp/sida.jsp?d=118&a=24300&language=en_US&searchWords=power%20analysis%202005

²⁷ http://www.gobernabilidaddemocratica-pnud.org/proyectos.php?id_pro=6&parte=1

	Settlement Mapping ²⁸ EC Country Political Economy Assessment (annex 1)	Briefing donor staff, and providing essential background for more informed policy dialogue.
Sector level analysis	EC Addressing Governance in Sector Operations ²⁹ ODI/DFID Analytical Framework for Assessing the Political Economy of Sectors and Policy Arenas ³⁰ EC Sector Political Economy Assessment (annex 2)	Gaining understanding of the interests and incentives operating at sector level, and how these affect sector performance and the potential for reform. Supporting donor programming decisions on the priority of different sectors. At identification stage determining priorities within the sectors, and approaches to supporting the sector, informing decisions on implementation modalities and gaining a better understanding of risks. Essential background for informed policy dialogue on the sector.
Problem focussed analysis	World Bank Problem-driven Governance and Political Economy Analysis ³¹ World Bank/SDD Political Economy of Policy Reform ³²	Deepening understanding of a specific policy or operational problem. At formulation stage to inform the design of specific projects and programmes. At implementation stage to address and remedy problems as they emerge.

²⁸ <http://asiafoundation.org/resources/pdfs/PoliticalSettlementsFINAL.pdf>

²⁹ See EC/EuropeAid (2008) Addressing Governance in Sector Operations, Draft Reference Document, July 2008 http://ec.europa.eu/europeaid/infopoint/publications/europeaid/149a_en.htm

³⁰ See Moncrieffe, J. and Luttrell, C. (May 2005). 'An Analytical Framework for Understanding the Political Economy of Sectors and Policy Arenas', Overseas Development Institute http://www.odi.org.uk/fecc/resources/reports/sector_analysis_framework_odi.pdf

³¹ World Bank (September 2009) Problem-driven governance and political economy analysis: Good practice framework, Verena Fritz, Kai Kaiser and Brian Levy. <http://vle.worldbank.org/bnpp/en/publications/governance/problem-driven-governance-and-political-economy-analysis> - NB This framework is also applicable at country and sector level

³² World Bank (2008) The Political Economy of Policy Reform: Issues and Implications for Policy Dialogue and Development Operations, Report No. – 44288-GLB, Social Development Department http://siteresources.worldbank.org/EXTSOCIALDEVELOPMENT/Resources/244362-1217517341604/PE_Reform.pdf

In addition to these three levels of analysis, recent studies have also focused on the effects of regional and international factors that influence in-country political economy³³.

The European Commission has also developed political economy analysis tools building on the work of other development partners. Annexes 1 and 2 to this paper provide suggested frameworks to be used by the EC for country and sector level political economy assessment. They consist of a structured list of questions for investigating how political and economic processes are playing out in a particular country or sector context. They should be viewed as tools that can be adopted and adapted by Delegations according to need.

The frameworks for Country and Sectoral Political Economy Assessment are not intended to be comprehensive and are not the only types of analyses that will be needed by Delegations. They can usefully be combined with other kinds of analytical tools including social networking analysis (to investigate the conditions for constructive collective action), non-state actor mapping³⁴, institutional assessments, conflict assessments³⁵, instability assessment³⁶, political settlement analysis³⁷ and growth diagnostics³⁸.

5.2 Country Political Economy Assessment

The framework for Country Political Economy Assessment is presented in annex 1. It is intended to inform the Country Context Assessment alongside other analyses of public financial management, macroeconomic management and key development policies. The Country Political Economy Assessment is structured around an examination of the interaction between structural factors, institutions and current “events”, all of which influence incentives and the potential for collective action. The analysis is organised around three broad headings:

- **Foundational factors** including the history of state formation, sources of public revenue, social and economic structures, geostrategic position and geography that

³³ See forthcoming OECD DAC study on the International Drivers of Corruption

³⁴ European Commission (2008) Methodological guide for implementing a mapping of civil society actors in latin american countries

https://webgate.ec.europa.eu/fpfis/mwikis/aidco/images/2/24/GUIDE_CIVIL_SOC_FINAL.pdf

³⁵ See DFID (2002) Conducting Conflict Assessments Guidance Notes - <http://www.dfid.gov.uk/documents/publications/conflictassessmentguidance.pdf>

³⁶ Netherlands Ministry of Foreign Affairs (2005) The Stability Assessment Framework: Designing Integrated Responses for Security, Governance and Development.

http://www.nbiz.nl/publications/2005/20050200_cru_paper_stability.pdf

See also - UK Cabinet Office (2005), Countries at Risk of Instability: Risk Factors of and Dynamics of Instability <http://www.gsdrc.org/go/display&type=Document&id=2950>

³⁷ Parks, T. and Cole and W. (2010), Political Settlements: Implications for International Development Policy and Practice, Asia Foundation - <http://asiafoundation.org/publications/pdf/745>

³⁸ Williams, G., Duncan, A., Landell-Mills, P. and Unsworth, S. (2009) Politics and Growth, *Development Policy Review* 27(1): 5-31 <http://www3.interscience.wiley.com/journal/121557141/abstract>

fundamentally shape the social, political and institutional landscape, and therefore influence incentives and behaviour.

- **Rules of the game** including the distribution of power, the nature of institutions, the basis for political competition, and key socio-economic trends, all of which shape the institutional incentives faced by different interest groups.
- **Here and now** which investigates what is driving day-to-day politics and decision-making.

Box 6: Using country political economy assessment in Zambia

Foundational factors include the colonial inheritance closely linked to copper production; and post-independence state building efforts. These contributed to peace and state resilience, but also to patterns of state patronage that undermined economic growth and diversification, and reduced capacity for collective action. Other foundational factors include geography and Zambia's geostrategic position as a frontline state.

Rules of the game are informal and highly personalised. There is some organised counter power from the ruling party, Roman Catholic Church and trade unions, and some institutional capacity within the bureaucracy. However political parties are not programmatic or institutionalised, and increasingly fierce political competition is fuelling corruption. Key socio-economic trends include a youth "bulge", a better educated urban middle-class including entrepreneurs with more autonomy from government; increasing Chinese and South African investment; and improved communications.

Here and now: the dominant event in June 2011 was the forthcoming election.

The analyst needs to identify the impact of these different factors on current development challenges, including how they influence political and economic incentives for reform, and prevailing public attitudes. The Country Political Economy Assessment then makes the link to operational questions by analysing the opportunities and constraints for change, assessing the level of influence of development agencies. The analysis should be relevant to country programme, policy dialogue, risk management, project and programme identification and formulation..

5.3 Sectoral Political Economy Assessment

The Sector Political Economy Assessment is intended to provide a broad overview of the sector to support programming choices covered in sections 4.2 and 4.3. Its conclusions should be relevant to the design of a Sector Policy Support Programme (SPSP) at the formulation stage. The conclusions should be reflected in the seven key areas of assessment for the preparation of an SPSP. It may also be necessary to commission more focussed problem-based political economy analyses to support particular aspects of the design of a Sector Policy Support Programme.

Annex 2 presents a suggested structure for the Sector Political Economy Assessment, which is summarised as follows:

- 1 Assessment of current sector performance and policies
- 2 Brief history of the sector and reforms
- 3 Key political economy issues and their effect on sector performance
- 4 Explaining the issues:
 - Mapping formal and informal institutions
 - Stakeholder analysis
 - Read across from country PEA
- 5 Key trends and potential drivers of change
- 6 What kind of institutional or policy reform is feasible? Room for manoeuvre
- 7 Operational implications for EC support to the sector

Section 6: How to do political economy analysis

6.1 Overview

Political economy analysis provides a structured way to address a broad set of questions about development context, processes and options. The analysis can be tailored to fit a variety of different purposes and circumstances. The guidance offered below – which draws on the experience of other donors including DFID, the Netherlands and the World Bank – should therefore be applied flexibly. It is important to be clear at the outset about objectives, available resources and audience, and to plan accordingly.

6.2 Country, sector or problem driven analysis?

The level of analysis will depend on the objectives. It can often be useful to start with an overview of country context. This will usually point to the need to drill down to the level of specific sectors and issues in order to explore detailed operational questions. It may be possible to start the process at the sector or issue level, but this depends on having a prior understanding of the broader, systemic issues at country level.

6.3 Purpose and partners

It is important to be clear at the outset about the purpose of conducting analysis. Objectives might include enhancing the understanding of EU staff; informing decisions about particular programmes; increasing coherence between development, commercial and diplomatic objectives; improving coordination with other donors; or using political economy analysis to inform dialogue with government and development partners.

Most political economy analysis has been undertaken with the objective of increasing the understanding of donor agencies' own staff. Both DFID and the Netherlands have found that carrying out analysis jointly between development and diplomatic staff has increased shared understanding and improved working relationships. Most political economy analysis has been undertaken without formal involvement of national governments, although informal consultations with key informants in government will often be productive. It should be expected that many of the questions raised by political economy analysis will be politically sensitive. While it is legitimate and necessary for donors to consider these questions, care will need to be exercised in how the analysis is presented to government. In particular, undertaking analysis jointly with a partner country government, especially if linked to the availability of aid money, significantly changes the dynamics involved and the implications should be considered carefully. Conducting analysis jointly with other donors can be a valuable way of increasing mutual understanding and cooperation, especially with Member States, but can involve high transaction costs. An alternative may be more informal arrangements for discussing and sharing outputs with other donors and external partners.

As increasing numbers of donors are undertaking political economy analysis it will be important to avoid duplication of effort. There will often be existing political economy studies or other written material that EU Delegation staff can draw on, as well as valuable advice

about process and contacts. They should therefore take care to consult other donors at the outset to benefit from their experience, and in particular to contact Member States to seek their support and discuss their possible involvement. It will almost always be important to involve them at least in a final workshop to validate findings and discuss implications. 6.4 Process

The EU Delegation will play the lead role in initiating and managing the process of conducting political economy analysis, including key decisions about scope, objectives and partners. However it can be useful to involve staff from headquarters, especially to provide insights from similar exercises elsewhere, and to act as a form of more independent peer review. Experience points to the key importance of involving the Head of Delegation or Head of Operations, and getting buy-in from staff representing a range of disciplines, including as appropriate the Political Adviser and Commercial Section staff. It can be helpful to set up a small internal steering group to manage the process, especially if external consultants are employed. Box 7 below draws on experience from piloting country and sector level work in Zambia.

Box 7 - Process for piloting country and sector level analysis in Zambia

EU delegation draws up terms of reference, tailoring the frameworks to their particular requirements, and appoints consultants.

Consultants make an initial scoping visit (about a week) to establish mutual understanding of objectives and expectations, gather locally sourced documents and carry out initial interviews.

A desk-based literature review of existing material.

An in country mission of 1-2 weeks to undertake the analysis, supplementing and validating written material with key informant interviews. Consultants prepare a report (based on the frameworks presented in section 5 above) highlighting how the political economy context helps explain development outcomes and challenges, and suggesting implications for programming.

A one-day workshop, including EUD staff and representatives from member states/other donors to discuss and validate the findings.

Revised report prepared to reflect workshop discussion.

6.5 Timing and timelines

Political economy analysis may be particularly relevant if carried out to inform programming decisions and programme design, but it can be useful at any point in the project and programme management cycle. It should be seen as an on-going process, not a one-off event: political economy analysis is most useful where it is integrated into the work of the Delegation, and is continually updated. The duration of the analysis will depend on objectives and resources available: political economy analysis can be used to brainstorm a problem at a one-day workshop, or involve detailed studies over a year or more (for example, DFID's large investment in the initial Drivers of Change studies in Nigeria and Bangladesh). How much time is needed will also depend on whether analysis is to be conducted jointly with others, as well as on the amount of relevant material already available.

6.6 Resources and expertise

Resource requirements can vary considerably, depending on whether the study involves drawing on existing material or conducting original research. Typically, Drivers of Change and SGACA studies have involved employing one or more external consultants, including an expert in using political economy analysis in a development context, and someone with excellent local knowledge and contacts. For the Zambia country level analysis, 27 days were allocated for the international expert, and 20 for a local consultant. Resource requirements for sector level studies will depend on the depth of analysis required, and will usually require more extensive interviews with local stakeholders. In Zambia it was possible to conduct a light touch review of the agriculture sector with 18 days of an international consultant's time because there was an extensive existing literature and well informed experts were easily available for interview. However, under more typical conditions 50-60 days of international and local consultant's time may be required.

6.7 Sources of information

For country level analysis there will often be **a good range of existing material** to draw on, including academic research, other donor assessments and political economy studies, World Bank and IMF country reports, official policy statements and documents (including laws, regulations and organisational strategies), political speeches, public opinion surveys and media reporting, reports of human rights commissions, civil society organisations and local think tanks. The World Bank Governance and Doing Business indices, The Transparency International Corruption Perception Index, the Bertelsmann Transformation Index, and reports from Civicus and Afrobarometer can all be worth consulting. More recommendations on suitable sources are provided in annexes 2 and 3.

However, in many cases **more in-depth, qualitative research** will be needed drawing on the knowledge and experience of key informants including politicians, civil servants, business people, the media and NGOs. This includes face-to-face interviews with key informants, focus group meetings, and stakeholder workshops. The aim should be to include a representative sample of interviewees from different regions and backgrounds. It can be especially difficult to gain access to information at the level of a sector or subsector about the institutional, financial and regulatory framework; different aspects of performance; and

informal practices and relationships. Understanding detailed patterns of rent creation and distribution, and how patron-client networks actually operate can be especially challenging. **Structured interviews with key informants** will be essential (either individually for sensitive issues, or in focus groups). Triangulation of evidence is critical in order to corroborate the claims of different respondents, and to assess the accuracy of "soft" information from interviewees against "harder" sources (for example, data on budget allocations, remuneration of staff and so forth). Local staff in Delegations can play an especially valuable role in helping to contextualise and interpret information.

6.8 Dissemination

It is important to take a view at the outset about the audience for any written product, and how it will be disseminated. In practice, even if political economy analysis is undertaken for internal consumption, it should be assumed that any report will become public (if external consultants are employed, the report can be presented as representing their independent view). Country level analysis is likely to be based largely on published sources and may be less sensitive than sector or subsector level studies that drill down more deeply into informal networks and relationships. Decisions about whether actively to disseminate findings need to take account of the sensitivity of the issues in a given country context. The default position is to make findings publicly available unless there are good reasons not to do so; and in any event to inform country partners that the analysis is being undertaken, and why. In most cases it will be appropriate to share at least a written synthesis product with a wider range of government and non-government stakeholders, or to present findings at a workshop.

6.9 Next Steps

In thinking about how to take political economy analysis forward within the Commission, it may be useful to consider the experience of other donors. This suggests:

The engagement of country level offices is crucial. While headquarters can initiate work on political economy analysis, building and sustaining support for it needs backing and leadership from EU Delegations. There is no substitute for in-country staff becoming actively involved in using political economy analysis tools. The exercise should therefore not be driven by headquarters, but led by Delegations. It is expected that interest will spread once initial results can be demonstrated.

Support from senior staff is vital to sustaining incentives for using political economy analysis. However, experience from other agencies suggests that **political heads of agencies** often find political economy messages hard to reconcile with strong incentives to focus on short-term results and normative objectives.

Managing expectations is crucial: political economy analysis highlights the depth of development challenges and the limited influence of outsiders. There are opportunities to increase aid effectiveness, but the strategies involved are often long-term and indirect, and measuring results can be difficult.

Encouraging internal debate through seminars, training and informal events is important in raising awareness, increasing understanding, challenging assumptions and learning lessons.

Political economy analysis can be particularly helpful in **building bridges between political and development actors**, especially in fragile situations. Even if they have different objectives, a shared understanding of context can help to find common ground.

Engaging with staff from a range of disciplines can deepen understanding of political economy issues and ways of using analysis. In DFID, for example, political economy analysis has been used in conjunction with growth diagnostics, and by natural resources and social development advisers. Within the Commission, applying political economy analysis to assessment of public financial management and macroeconomic issues might be particularly beneficial.

There are significant implications for staff skills, organisation and aid instruments.

These might include longer in-country postings, incentives to enhance country knowledge, more specialist staff In Delegations, more flexible ways of responding rapidly to opportunities to support change processes.

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