

The Political Economy of Business Environment Reform: An Introduction for Practitioners



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Executive Summary

This paper is designed as an introduction for PSD professionals – specifically those engaged with business environment reform – to the challenges posed to their work by issues of political economy. Whilst it is intended that this document will also be of use to other development professionals, it is a primer designed as an introduction to the issues rather than a comprehensive insight into all aspects of political economy. Most donor agencies have access to experts in this area: PSD professionals should make the best use of this resource as part of their work.

‘Political economy’, although the topic of this paper, is not a very helpful expression. It sounds rather academic and removed from the day-to-day challenges of development professionals. The first section of this paper therefore looks at four country examples as illustrations of the types of challenges that we mean when we talk about political economy. It is important to note that, although the focus of this paper is on developing economies, the ease and direction of reform in developed countries too are influenced by issues of political economy. The countries profiled in this first section therefore are not in any way singled out as being unusual: they are used to illustrate the types of challenges that business environment reformers may have to address.

The second section of this paper considers how political economy issues impact on the drivers of change (DOC) which are seen as being fundamental to business environment reform. Many agencies have developed DOC or other similar analyses. This chapter uses the World Bank’s matrix to illustrate the wide impact of political economy issues.

Section three provides insights about how business environment reformers can address the challenge of political economy. It looks at examples of good practice and sets out a number of tools and approaches that can guide others in overcoming issues that they come across. This section does not provide a definitive list of all possible tools, but gives illustrations of approaches that have worked and explores how best to stimulate demand for reform.

Section four provides practical hints and tips: the ‘fieldcraft’ which PSD professionals need to adopt in order to optimise their ability to deal with political economy issues. Once again, this section is not exhaustive; it provides reformers with a tangible set of actions. The aim is to give users of this guide some specific tasks or activities that will enable them most effectively to understand and respond to the challenges that political economy poses to their work.

Section five draws together the previous sections and lays out a typology of some of the political economy issues that PSD reformers might expect to face, and sets out some ideas as to how these might sensibly be analysed and addressed. Whilst far from being an exhaustive list, this section provides illustrations of how political economy challenges can be tackled. Finally, some key documents, analyses and tools are listed in a bibliography.

1: What is Political Economy, and why is it important

For practitioners, the expression 'political economy' is not perhaps a very helpful one. It has the air of something academic, rarefied and detached from the day-to-day business of development activity. However, as this chapter will attempt to demonstrate, even if the expression 'political economy' seems rather abstract, the issues that this expression incorporates are anything but. In fact the contrary is true: success in PSD programming is dependent to a very high degree on the issues that are contained within the concept of political economy.

'Political economy' as a discipline considers how political institutions, the political environment and the economic system influence each other. The structure of a country's governmental institutions; whether or not it has a functioning democracy; the relationship between different elements of government; the character of, and relationships between key political figures: these issues and others relating to the host country's political architecture are all relevant to the economic sphere. Economic development cannot properly be understood without taking account of the political dimension.

But what does this mean for PSD? Simply put, it means that a country's political system and institutions impact on the economic domain, and therefore also on programmes of business environment reform and other PSD interventions. Thus the ability of business environment reformers to do their job will be constrained by the political economy of the country they are working in. Reforms are much more likely to succeed if they are designed based on knowledge and understanding of local political economy factors, and conversely reforms failing to take account of these may fail. As a recent World Bank publication argues, "understanding contexts more thoroughly can help improve development effectiveness."¹

As the DCED's 2008 Guidance makes clear, "business environment reform processes are intimately connected with the political economy of change."² This includes the system of accountability and governance exercised within and on the state, the extent to which the state is open or captured, and the extent to which its policy-making processes are open to influence." As this document makes clear, the specific issues will differ country-by-country and there are no formulas that may be imported from elsewhere. However, it also acknowledges that "while development agencies cannot change the political economy of a country, a better understanding of these issues will improve the design and execution of reform programmes." This introduction therefore seeks to provide insights that will help business environment reformers to understand and respond to the issues they face in their countries of operation.

¹ World Bank (2011) *How to notes: Political Economy Assessments at Sector and Project Levels*. World Bank, Washington p2

² Donor Committee for Enterprise Development. *Supporting Business Environment Reforms: Practical Guidance for Development Agencies*, 2008.

The significance of the political and institutional system to the potential for reform is very pertinently illustrated by the developments in the Middle East and North Africa during the first few months of 2011. These events took everyone by surprise, and completely altered the politics and structures of many countries. The so-called 'Arab Spring' saw popular uprisings across the region, and the unseating of long-established regimes such as those of Hosni Mubarak in Egypt and Zine El Abidine Ben Ali in Tunisia. Both men had held their country's presidency for a quarter of a century or so, and political structures and institutions appeared to be very deeply embedded. For decades political and economic power rested in the hands of a small inner circle of those close to the president, and opposition was strongly resisted. Yet, within a few days these and other regimes had crumbled. As a result, from the perspective of business environment reformers (and indeed everyone else) the potential for, and processes to enact change had altered completely. Structures and specific contacts which would have become familiar had also entirely changed.

However, rather than arguing in the abstract, it is probably more valuable to look at some specific country examples to consider how aspects of political economy are fundamental to the challenges of reform, but also how an awareness of these challenges has guided business environment reformers in the focus of their activities. The following country examples are not in any way designed to single these countries out or to provide an exhaustive inventory of all the issues that can appear; they merely illustrate some of the challenges that issues of political economy can pose for business environment reformers, and illustrate some responses to these. The challenges of political economy may appear daunting, but they need not be insurmountable. Indeed, a proper awareness of the political economy of a country can provide excellent insight into the issues of business environment reform that will need to be prioritised.

Azerbaijan

On the surface, Azerbaijan seems to be doing very well: UN figures state that the country enjoyed annual GDP growth of 21.1% from 2003 to 2007.³ However, this impressive economic growth does not reflect the result of an ambitious, thorough-going and comprehensive reform programme. Rather it primarily reflects the huge oil and gas developments in the country. According to the Economist Intelligence Unit, "rapid economic growth has been almost entirely attributable to the massive inflows of FDI to the oil sector."⁴ By contrast, the rest of the economy has atrophied, and has changed little since the country's days as part of the USSR. For example, manufacturing accounted for about 33% of industrial production in 2002, down from 60% in 1990.⁵ The country therefore divides into two – 'greater Baku' which is benefitting from the oil boom, and the rest of the country. Reform is urgently needed to deepen and broaden economic growth, but remains an incomplete process. Understanding why requires an understanding of the political economy of the country.

³ Office of the UN Resident Co-ordinator in Azerbaijan (2008) *Annual Report 2008 of the Resident Coordinator on behalf of the United Nations Country Team in the Republic of Azerbaijan* p1

⁴ Economist Intelligence Unit (2003) *Country Profile: Azerbaijan EIU*, London p26

⁵ Economist Intelligence Unit, p30

According to the International Crisis Group (ICG) a key political economy challenge in Azerbaijan is the basis of political power. The political system is centralised and autocratic with the President's basis of legitimacy relying heavily on traditional family and clan ties, supported by oil revenues and government patronage. ICG describe the Azeri government as "a carefully designed autocratic system ... with heavy reliance on family and clan members, oil revenues and patronage." One academic observer argues that, "President Aliyev has entrusted all important national and regional posts to his clansmen and family members," and that the principal infrastructure and industry of the country is controlled by these people and their clans.⁶

In the view of the US Department of State, the allocation of public assets among different power groups has very significant impacts on the potential for reform and economic development. Its 2009 review of investment in Azerbaijan argued that "government bureaucracy, weak legal institutions and predatory behaviour by politically connected monopoly interests continue to hinder investment outside of the energy sector."⁷ Commentators argue that the clans obstruct investment and development because they believe that opening sectors up to foreign companies would result in their losing control. However, some reform has proved possible despite these governance challenges. To encourage foreign investment, a one-stop-shop for business registration has been created, which has halved the time, cost and number of procedures to start up a business. President Aliyev issued a decree mandating improvements in the business registration system and reducing the number of procedures required for starting a business.⁸ In the World Bank 2009 "Doing Business" Report, Azerbaijan jumped 64 places from 97th to 33rd.

Some observers, like Professor Richard Auty argue that Azerbaijan's wealth may be a challenge rather than an asset since it means that the government can put off the systematic and strategic reforms necessary to develop their economies over time. In a study of the whole Caspian region, Auty – an observer of the so-called "resource-curse" – argues that economic reform and restructuring of the economy has proceeded faster in the resource-poor countries, and that "movement towards an enabling government is most likely with low natural resource rent."⁹ In Auty's view governments that have little or no resource rent on which to rely have to reform and restructure their economies if they are to maintain stability. As a result, they are better structured for stable long-term economic and financial growth. By contrast, governments like that of Azerbaijan can rely on resource revenues to defer needed reforms with the result that the underlying economic problems are not resolved. Because of the lack of economic reform the rest of the economy remains underdeveloped.

Furthermore, Azerbaijan's oil wealth has made corruption a major issue of concern. In the view of the US Department of State for example, "corruption is a significant deterrent to investment in

⁶ Sim, Li-Chen (1999) *In Search of Security: Azerbaijan and the role of oil in the Caspian sea*. In *Journal of Communist Studies and Transition Politics* Vol 15 No 3 Sept 1999 p28

⁷ US Department of State (2009) *2009 Investment Climate Statement – Azerbaijan* February 2009

⁸ Presidential Decree 567 of 30 April 2007 "On Some Measures Regarding the Development of Entrepreneurship in Azerbaijan Republic"

⁹ Auty, R. 'Natural Resources, Governance and Transition in Azerbaijan, Kazakhstan and Turkmenistan' in Akiner, S (ed) *The Caspian: Politics, Energy and Security* Routledge Curzon, London. 2004 p113

Azerbaijan.”¹⁰ Here again however, rather than regard this issue as insurmountable, business environment reformers have succeeded in tackling some elements of the problem. Azerbaijan is a fully-compliant member of the Extractive Industries Transparency Initiative, which was introduced to the country in 2004. Observers make clear that the implementation and success of this initiative was driven by a coalition of international oil companies that wished to avoid association with corruption; local NGOs seeking to ensure that the benefits of the country’s oil wealth accrued to the population at large, not a small elite; the government wanting to be seen to be moving on corruption so as to not discourage future investment.

Bosnia

There is general agreement that the structures put in place by the Dayton Peace Accords which brought the Bosnian war to an end are a major hindrance to the process of business environment reform, and indeed reform more broadly. One observer argues, Dayton “provided the country with an extreme state structure – as complex as it is dysfunctional ... This has produced an oversized and mostly ineffective administration, as well as an exceptionally unwieldy decision-making process, resulting in urgent reforms being put off.”¹¹ The country consists of two ‘Entities’; the predominantly-Serb Republika Srpska which controls 49% of the country’s territory, and the Federation Bosnia and Herzegovina (FBH) which is inhabited by Bosniaks and Croats. The latter is broken down into 10 cantons which each have a separate premier and cabinet. The country has a 3-person Presidency, one Bosniak, one Croat and one Serb, who rotate every 8 months.

Commentators argue that these structures put a number of obstacles in the way of reform. The most obvious is one of cost. The complexity of BiH’s governmental structures means that they are expensive to run. They cost, according to the European Union, 56% of GDP to fund.¹² In addition, many argue that the political arrangements positively encourage politicians to appeal only to their ethnic group. Given the strict three-way division of political offices, no politician has an interest in appealing across the ethnic divide. As Professor David Chandler argues, “politicians who have little representational legitimacy are unlikely to build bridges within society and lack the capacity to resolve conflicts”.¹³

However, Professor Richard Caplan and others argue that the structures put in place by the international community to overcome these domestic political challenges are just as problematic. Caplan argues that the propensity of the international community to step in if domestic politics stalls “undermines the concept of democratic decision-making, and so sends the wrong message to a people whose democracy is still in its infancy.”¹⁴ The structures he refers to are the so-called ‘Bonn

¹⁰ *Ibid*

¹¹ Solioz, C (2005) Turning points in post-war Bosnia. Nomos, Baden-Baden, p107

¹² European Commission *Bosnia and Herzegovina Country Strategy*, p10

¹³ Chandler, D. ‘Bosnia’s new colonial governor: Paddy Ashdown is turning its elected leaders into his ciphers’. In *The Guardian*, London 9th July 2002

¹⁴ Caplan, R. ‘International Authority and State-Building: The Case of Bosnia Herzegovina’. In *Global Governance* 10 2004, p61

Powers' of the Office of the High Representative (OHR), which represents the international community in Bosnia: these allow the international community to push through reforms without reference to local politicians. Another observer accepts that these powers have "contributed to a slightly better present for its citizens and open up better prospects – however tenuous – for their future ... [they] are probably not consistent with the longer term aim of fostering genuine pluralism and rule of law in BiH."¹⁵ The Bonn Powers present obstructions to accountable decision-making by local politicians.

Those working in the country argue that a further problem is that merit is not the primary criteria in human resource management for the people working in the government structures. Civil servants' appointments are driven as much by their ethnicity as they are by their qualifications and suitability for the job.

The result for the business environment is that, even 15 years after the Dayton Agreement, as Dutch economist Willem Buiter observed, BiH suffers from a "dreadful business and investment climate".¹⁶ In 2008 the Foreign Investors Council (FIC), which is made up of both foreign investors and local businesses produced a 'White Paper' detailing what they saw as the main problems with the business environment. The White Paper identifies a number of key obstacles to foreign investment.¹⁷ The first is overlapping, non-standardised policies and procedures for obtaining permissions required for doing business, stemming from the number of different jurisdictions in the country. Secondly, the country suffers from un-harmonised and excessive taxes as the result of the cost of the bureaucracy. Thirdly, there are burdensome construction permissions and procedures, as a result again of the multitude of administrative areas. According to local businesses, it requires 52 signatures to get construction authorisation in Sarajevo. Fourthly there is limited access to business finance, and to capital markets.

The World Economic Forum Competitiveness Report places the country 95th out of 117 countries, and the World Bank's World Business Environment Survey ranks BiH 140th out of 175 countries surveyed. The Foreign Investment Promotion Agency states that the process of establishing a business should only take 15 days although it accepts that "due to technical difficulties ... [it] may take up to 30-45 days."¹⁸ However, the experience of business-people is that even this timescale is not realistic: the Foreign Investors Council say it can take as long as 6-7 months.

However, as with the case of Azerbaijan, these challenging circumstances do not mean that meaningful reform is not possible. The Bulldozer Initiative was established in November 2002 by the OHR, with the backing of the IMF, World Bank and the European Commission, and explicitly

¹⁵ Bose, S. 'The Bosnian state a decade after Dayton'. In *International Peacekeeping* Vol 12, No 3 Autumn 2005, p331

¹⁶ Buiter, W. *Designing Effective Economic and Structural Reform Policies for Bosnia Herzegovina* Presentation to development community in Sarajevo, June 2007, p14

¹⁷ Foreign Investors Council. *FIC White Paper 2007: Priority Solutions for Obstacles to Investment and Growth in Bosnia and Herzegovina*. FIC, Sarajevo. 2007

¹⁸ Foreign Investment Promotion Agency (2008) *Investment Opportunities in Bosnia and Herzegovina* FIPA, Sarajevo p33

recognised that FDI was impeded by overly complex bureaucracy. Its goal therefore was to harness the expertise of the business community “to bulldoze barriers by identifying concrete legislative changes and advocating for their adoption and implementation.”¹⁹ Through public meetings in eight cities the committee received 250 recommendations of regulations that needed to be ‘bulldozed’. Of these 50 reforms were adopted by both the federal and the Entity governments. The changes include easing the BiH entry visa regime for foreign nationals; removing the need for registration of foreign representative offices in both Entities; and shortening procedures for increasing bank capital. There seems to be widespread agreement that the project was a success. The EBRD’s 2003 strategy paper said that the Bulldozer Initiative represented significant progress in the push for a single economic space in BiH.”²⁰

Nonetheless, most observers believe that reform of the business environment will only be possible if larger issues are addressed by others in the development community and within the Bosnian authorities. As the EBRD argues “The major challenge for the country in the near future will be constitutional reform, without which further progress towards a more democratic and efficient state ... will be difficult to achieve.”²¹

Rwanda

Rwanda is often presented as the poster child for business environment reform. In the World Bank’s Ease of *Doing Business* index, Rwanda was ranked 67th in the world, an impressive improvement from 148th in 2008. Moreover, there is wide agreement that the President’s *Vision 2020* strategy for the country, which aims to make Rwanda a middle-income country within the next decade, identifies the key development challenges facing the country. It forms the basis for the country’s work with donor agencies. The World Bank, for example, makes it clear that “our programs are firmly aligned with Vision 2020 implementation.”²² Donors welcome a government that has a clear programme.

However, despite progress in reforms the government retains a high degree of control over the country generally. Much as in Azerbaijan, political power is highly centralised, with decision-making kept to a small group, and legitimacy built on patronage networks referred to as *akazu*. The International Crisis Group, for example, argues that President Kagame’s administration “wields almost exclusive military, political and economic control and tolerates no criticism or challenge to its authority.”²³ Professor Filip Reyntjens argues the same: that in Rwanda, “a small inner circle of RPF leaders takes the important decisions ... [and] a clientilistic network referred to as the *akazu* accumulates wealth and privileges.”²⁴

¹⁹ Herzberg, B. *Investment Climate Reform: Going the last mile. The Bulldozer Initiative in Bosnia and Herzegovina*. World Bank Investment Climate Unit, Washington DC. 2004, p2

²⁰ European Bank for Reconstruction and Development. *Strategy for Bosnia and Herzegovina*. EBRD, 2003, p23

²¹ *Ibid*, p17

²² World Bank. *Country Strategy for Rwanda FY09-FY12*, p32

²³ International Crisis Group (2002) *Rwanda at the end of the Transition* ICG, Nairobi and Brussels p1

²⁴ Reyntjens, F. ‘Rwanda, 10 years on: From Genocide to Dictatorship’. In Marysse, S & F Reyntjens *The Political Economy of the Great Lakes Region* Palgrave MacMillan. 2008, p27

From the perspective of the business environment, the most direct impact of this strong centralised government control is felt through the influence in the economy of Tristar. Tristar is the government's own investment vehicle, through which it controls stakes in many companies in the country. For example, Tristar owns 65% of Banque Populaire du Rwanda; 30% of the brewer Bralirwa and 20% of Banque Commerciale du Rwanda. It is reported that the problem is that Tristar is not transparent in its strategy and actions: as one commentator observes, Tristar is "shrouded in secrecy."²⁵ As a result, commentators observe, there is a lack of transparency in the commercial sector, and that doing business requires contacts with the right people – "getting things done requires networking with the right people".

The genocide also continues to make itself felt through what the Government itself calls, "the severe shortage of professional personnel [which] constitutes an obstacle to the development of all sectors."²⁶ This results both from the sheer numbers killed in 1994, and the disruption to the education of those who did survive. The most obvious impact is in companies' inability to hire properly qualified staff. According to the Rwanda Private Sector Federation, 40% of businesses report difficulties recruiting properly-trained staff.²⁷ There is general agreement that this skills shortage also causes inefficiency within Government - a problem that is reported to be particularly marked within the Rwanda Revenue Authority (RRA). According to the Private Sector Federation, while "businesses of all sizes and nearly all sectors and regions identified corporate tax rates as the number one fiscal constraint that needs to be addressed... time spent dealing with taxes [is] a greater problem than tax rates, as a result of poor, unfriendly services rendered by the Rwanda Revenue Authority".²⁸ The focus of the criticism is what is perceived to be the inflexibility of the RRA's approach, and the fact that they are 'judge and jury' on all tax matters.

Efforts are being made to address this skills issue. For example, Rwanda is a beneficiary of the e-schools programme being run as part of the NEPAD e-Africa Commission. At a tertiary level, in 1997 the Government established the Kigali Institute of Science and Technology (KIST) "to address the skills gap in technology."²⁹ However, many observers question the effectiveness of these training efforts. Writing about KIST, a World Bank report concluded that the food science and technology graduates of the Institute have "no meaningful practical experience, the subject being taught almost entirely in theory. They are thus of little use or interest to industry."³⁰ More broadly, 57% of members of the Rwanda Private Sector Federation report that a lack of "local availability of relevant training [is a] major problem" for their business.³¹

²⁵ Dietrich, C. 'The commercialisation of military deployment in Africa'. In *African Security Review* Vol 9 No 1, 2000.

²⁶ Government of Rwanda, *Vision 2020*, p7

²⁷ Rwanda Private Sector Federation. *Business and Investment Climate Survey 2008*. RPSF, Kigali. 2008, p7

²⁸ Ibid, p39

²⁹ Kimanuka, O. *Sub-Saharan Africa's Development Challenges: A case study of Rwanda's Post-Genocide experience* Palgrave MacMillan, New York. 2009, p90

³⁰ Watkins. A & A Verma. *Building Science, Technology and Innovation Capacity in Rwanda* World Bank, Washington, DC. 2008, p39

³¹ Rwanda Private Sector Federation, p40

Rwanda's developing relationship with its neighbours is also a significant factor relevant to business environment reform. As the Government makes clear, "Rwanda considers regional economic integration as one of the crucial elements of achieving Vision 2020." President Kagame has been explicit in his ambition to develop Rwanda as a service hub for the region, seeing countries like Singapore and Switzerland as models.³² Also, Rwanda is a member of the East African Community whose ambitions to create a single economic space and a single currency are seen as having significant implications for Rwanda. However, the weak regional infrastructure acts as a barrier to broadening markets.

Once again, therefore we see the implications for business environment reform of political economy. Rwanda's rise up the *Doing Business* rankings demonstrates that the Government's focussed approach, and support from donors can achieve impressive results. Yet despite its improvements in this domain, Rwanda remains highly aid-dependent and the business sector remains small and diffuse, with at least two-thirds of enterprises in the informal sector and foreign investors still scarce.

Uganda

Uganda's process of business environment reform has been steady, but slow. It was ranked 112th in the *Doing Business* rankings for 2010, slipping six slots from the previous year. According to the World Economic Forum's Global Competitiveness Report for 2007-08, the three most problematic factors for doing business in Uganda are access to finance, corruption, and inadequate supply of infrastructure. According to the Enterprise Survey, over 60% of the firms cited electricity as the largest constraint to investment. However, reform also faces challenges from a number of key political economy issues.

At an institutional level, business environment reform is hindered by the fact that responsibility for this process is divided between a number of different ministries and agencies. Although there is a Competitiveness and Investment Climate Strategy (CICS) group within the Ministry of Trade, it is relatively small, and the host ministry seen as relatively weak and lacking in influence at ministerial level. Donor agencies are providing considerable support to the CICS Secretariat, but the diffuse responsibility for reform is seen by these donors as a major challenge.

Business environment reform is also hindered by weak political support at senior level. Although the Government declares itself to be private-sector oriented and active in prioritising PSD, only four bills in relation to the Competitiveness and Investment Climate Strategy have been approved by the Government since 2006. Commentators argue that this is due to the lack of a champion for PSD-related reforms, and especially a lack of active Presidential support.

Growing political instability is also a concern, particularly in the lead-up to the 2011 elections. For example, International Alert argued in a recent report that "current press reports and political

³² Kagame, P. *Africa and Rwanda – from Crisis to Development* Speech to Lee Kuan Yew School of Public Policy, Singapore 22nd May 2008

commentary increasingly complain that the government favours members of President Museveni's own tribe – the Banyankole – as well as other “westerners”.³³ Observers also point to growing dissent within the ruling NRM. Given that this party has been in power, and the source of governmental stability, since 1986, political infighting within the NRM is regarded by commentators as a matter of some concern. As those in the ruling elite struggle for their own political position, so the attention paid to business sector reform wanes.

The exploitation of Uganda's recently discovered oil resources is seen by many as likely to complicate the political situation still further. Current estimates put the country's oil potential at approximately 1.5 billion barrels of recoverable reserves. This would place Uganda among the foremost of African oil producers and at least double export earnings.³⁴ Observers fear that this new wealth will exacerbate existing political tensions with different factions seeking to extract maximum benefit. This concern is given credence by reports which suggest that Uganda is resisting pressure to join the Extractive Industries Transparency Initiative designed to eliminate corruption from oil revenue payments. For example, a review of Uganda's contracts commissioned by the Norwegian Agency for International Cooperation (Norad) in 2008 concluded that the profit-share model adopted "cannot be regarded as being in accordance with the interests of the host country".³⁵

A further challenge related to the oil industry is the fact that it is not labour-intensive. With more than 50% of the population below 15 years old and with nine dependents for each person employed, one of Uganda's biggest challenges is therefore employment creation in the formal private sector. Since more than 70% of economic activity currently takes place in the informal sector, job creation in the formal sector is also a priority from the perspective of tax generation.

There is also a need to tackle the legacy of the war in the north of the country, which all but cut off that region for decades. With an official peace agreement signed in 2007 and the Lord's Resistance Army pushed out of the country, Northern Uganda is generally described as safe and stable. However significant challenges remain. Development agencies working in the region report that the north's infrastructure has become very dilapidated and needs urgent attention. It is also reported that as internally displaced people move out of camps and back to their villages, they lose the markets they had built within the camps. Therefore, market development and value chain approaches are a priority for PSD programming in the North. This challenge demonstrates a further reality about tackling political economy issues: that they are not just different country-by-country, but even within countries.

³³ International Alert (2009) *Harnessing Oil for Peace and Development in Uganda*. International Alert, Kampala. p 5

³⁴ Ibid, p4

³⁵ Norad (2008) *The Capacity Building Programme for strengthening the State Petroleum Administration of the upstream petroleum sector in Uganda*. Norad, Oslo p39

2: Drivers of Change: The challenge of political economy

Precisely the problem with political economy analysis is that the issues are country-specific. The country examples given above demonstrate both the range of issues that need to be taken into account, but also the complexity of the interaction between the issues. No guide to political economy can ever provide a definitive list of issues that need to be considered: practitioners need to develop the observational and analytical skills to establish what the key issues are in the country in which they are working.

Moreover, political economy issues are dynamic and will always change. Over time some issues will wane in importance, but others will emerge. Monitoring this change, and understanding how this will impact on business environment reform – to make it more or less likely – needs to be a continual process, not an episodic one.

Many donor agencies have sought to understand what they believe are the key factors that need to be addressed if business environment reform is to be successful: so-called ‘drivers of change’ (DOC). These analyses recognise that the external environment in a host country – its political economy - is key to the success or failure of business environment reforms. DFID, for example developed a DOC approach based on the need to “understand the mechanics of pro-poor change.” According to DFID, the approach “aims to identify the opportunities, incentives and blockages to pro-poor change at country level.” This model identified three sets of factors and recognised the importance of understanding the interaction between them. These three sets are:

- Agents: Agents are the various individuals and organisations which pursue particular interests. They include the political elite, civil servants, political parties, the private sector, civil society groups and the media. The different sets of interests of each of these groups, argues the DFID analysis, will significantly impact on the scope and potential success of reform processes.
- Institutions: These include the rules that govern the behaviour of agents, such as public and political processes. These include more informal ‘rules of the road’ as well as formal rules. Institutions, it is argued, are more susceptible to change in the medium term.
- Structural features: These are factors relating to the way in which a state is structured. These include the history of state formation, economic and social structures, urbanisation and regional influences. As DFID point out, these factors are deeply embedded and are slow to change.

Sida has developed what it calls a ‘power analysis’ approach, seeking to map where power lies in society. This approach apparently arose from an analysis of the agency’s support to Ethiopia between 1996 and 2001, which demonstrated that little progress had been made in terms of poverty reduction despite the assistance received. It was recognised that the power structures in Ethiopia were poorly-

understood and needed to be analysed better. A parallel piece of work had demonstrated also the importance of understanding informal as well as formal structures in designing market interventions.

More recent work from the World Bank identifies seven 'drivers of change' "that expand the opportunities for reform"³⁶. These build both on the Bank's previous *Institutional and Governance Reviews*, and the experience of other agencies. As with the DFID and Sida analyses, these drivers of change seek to explain how wider societal factors impact on the process of business environment reform. The most recent addition to this corpus of work, *Political Economy Assessment at sector and Project Levels*, explains how project officers can seek to understand the political economy issues likely to affect their programmes.

The previous section of this report demonstrated the complexity of political economy issues, and how many factors overlap and inter-play. Taking the seven drivers of change identified by the World Bank as an example, the following paragraphs demonstrate how a country's political economy can impact on all of these drivers, and no business environment reform programme can be contemplated which does not seek to understand and manage these complicating factors. The use of the WBG analysis, rather than those of other organisations does not seek to privilege this approach above others. The aim of the following analysis is purely illustrative, using the most recent DOC analyses.

Globalisation

The World Bank argues that the forces of so-called globalisation mean that "governments are forced to engage in regulatory competition."³⁷ The example of Azerbaijan demonstrates that this is not always the case. On one level Azerbaijan has done very well from globalisation: its new-found wealth is based on its hydrocarbon exports. However, as Auty argues³⁸, oil and gas revenues have enabled the Aliev government to avoid thorough-going structural reform.

Crisis

"A crisis or a sense of impending crisis can be important at the start of reforms and can provide an opportunity to stimulate action," says the World Bank. Again, this is not necessarily the case. In Bosnia, the Dayton Accords brought to an end a war, yet the general consensus of observers is that this failed to provide the impetus for proper reform.

Political Leadership

The World Bank and other agencies frequently regard business environment reform, and indeed other reform processes as being *a priori* goods. A reformed state is a more efficient one which will therefore be attractive to all. Yet for political leaders in host countries, reform may be less evidently beneficial,

³⁶ World Bank (2009) *Lessons for Reformers: How to launch, implement and sustain regulatory reform*. World Bank, Washington DC. p2

³⁷ *Ibid.*

³⁸ Auty. R (2004) *Natural Resources, Governance and Transition in Azerbaijan, Kazakhstan and Turkmenistan* In Akiner. S (ed) *The Caspian: Politics, Energy and Security* Routledge Curzon, London pp109-126

since it may upset long-established power patterns. The cases in the previous chapters provide good examples of this. In Azerbaijan, the analysis of the US Department of State is that “predatory behaviour by politically connected monopoly interests continues to hinder investment outside of the energy sector.”³⁹ In Bosnia, local political leaders have shown themselves more interested in pursuing ethnic interests and “lack the capacity to resolve conflicts”.⁴⁰

Nevertheless, the examples of Rwanda and Azerbaijan demonstrate what is possible when political leaders’ support can be secured for specific reforms. Both countries’ improvements in the World Bank’s *Doing Business* indicators are regarded as having come about because of the impetus delivered by presidential support.

Unfolding reform synergies

The World Bank argues that “market-oriented reforms in one area can increase pressures for reform in other areas.” Once again this is not necessarily the case, quite possibly because the obstacles vary depending on what reform is attempted. In Rwanda for example, cutting red tape was possible because of strong Presidential support and collaboration with the donor community with the result that the country has improved dramatically in the ‘*Doing Business*’ indicators. Yet wider reform is hindered by different challenges; a low skills base in the country, for example. Bosnia, conversely, demonstrates that business environment reform can be dependent on wider constitutional reforms. In that country, the challenge facing reformers of the business environment will not be resolved until wider constitutional reforms are put in place

Technocrats

The World Bank is quite right to argue that “reform can be driven by technocrats ... who develop rational policies to lead the country forward.” Likewise, an absence of properly trained professionals can seriously impede movement to reform. In all four countries, the level of competence of government officials represents a significant obstacle to reform. Even where systematic reforms have been attempted, there is a lack of capacity, particularly lower down the hierarchy, to implement these reforms and make them work. In Rwanda for example, the on-going demographic impact of the 1994 genocide means that there is a shortage of skilled administrators and technocrats even immediately below the most senior levels of the civil service. Development programmes overall often include educational and skills programming. However, it is apparent that this issue is one that is highly relevant to the reform agenda.

Changes in civil society

In Central Europe the existence of a strong civil society was frequently cited as a significant factor in the success of the economic reforms there from 1989. The examples in the previous chapter demonstrate however that it is necessary to see ‘civil society’ encompassing all non-state actors, not

³⁹ US Department of State (2009) *2009 Investment Climate Statement – Azerbaijan* February 2009

⁴⁰ Chandler, D. ‘Bosnia's new colonial governor: Paddy Ashdown is turning its elected leaders into his ciphers’. In *The Guardian*, London 9th July 2002

just NGOs and similar pressure groups. Both Bosnia and Rwanda demonstrate the potential of chambers of commerce as drivers of reform. In both countries, respectively the Foreign Investors Council and the Rwanda Private Sector Federation have produced detailed analyses of the challenges facing the private sector which are proving catalytic in demonstrating the need for further reform.

External pressure

The World Bank concludes that “external pressures are often essential to reform ... external obligations allow reform-minded governments to shift responsibility and hence the political costs of reform.” The success of both Rwanda and Azerbaijan in ascending the World Bank’s *Ease of Doing Business* index demonstrates that external pressure can be effective. In both cases, the country’s President perceived it to be important that his country performed well in this international comparison, and made sure the necessary reforms took place.

However, the cases in the previous chapter demonstrate that external pressure can also be problematic. In Bosnia, as observers make clear, whilst the use of the Bonn Powers of the OHR have been effective in making change happen, this has been at the cost of by-passing local decision-makers. In Uganda, the strong and consistent support that the donor community has provided to the CICS Secretariat has not translated into faster or greater reform.

3: Addressing political economy issues: tools for analysis and implementation

So far this paper has identified some of the ways in which political economy factors complicate sensible economic and business environment reform. But what can PSD practitioners do to address these challenges? What approaches and tools may be relevant in ensuring that necessary reforms can be successfully navigated around the rocks of political economy?

A short paper like this is not going to be able to provide a complete answer to all the challenges that PSD practitioners might face. What this section attempts to do therefore is to identify a few of the tools and approaches that others have used in overcoming political economy obstacles to reform.

Analysis

Perhaps self-evidently, a crucial step in managing the impact of political economy factors on the processes of reform is to identify precisely what the potential obstacles might be. Patrick Banya's analysis of the reform experience of Kenya, Tanzania, and Uganda illustrates the types of issues that need to be identified.⁴¹ Banya's analysis shows that the success or failure of legal and regulatory reform initiatives and other reforms in East Africa has depended on political stability and predictability. Although Uganda has enjoyed a measure of political stability, the recent transition from single party to multi-party politics was associated with a level of policy uncertainty. The political agenda dominated while economic policy issues and decisions were given secondary priority during this period. This handicapped the reform process and slowed down implementation. In Tanzania, the stability enjoyed since independence has not necessarily afforded the country a superior political environment within which better regulatory reform can be pursued.

Banya's study concludes that before starting any better regulation reform initiative, it is important for development partners to take the time to understand the local political economy in which regulatory reform will need to take root. The experiences of Uganda, Tanzania and Kenya suggest that such a review should at a minimum include the following issues:

- The level of political commitment to reform at different levels of government
- Identification of potential institutional champions both within the public and private sectors that can drive and manage the reform process;
- Understanding of institutional drivers, incentive structures, legal tradition, history of policymaking, cultural factors and other local conditions that are likely to have a bearing on the reform effort.
- Identifying "winners and losers" under reform is important for gauging how successful the process might be

⁴¹ Banya, Patrick and Waddington, Richard, "Getting to Better Regulation: Lessons from East Africa", *DCEP Conference Accra 2007*

Various development agencies have created tools designed to help analyse the political economy of a host country. Their aim is to provide frameworks for rigorous analysis at each level of the business sector, requiring donors and development agencies to take account not only of local-level constraints in a particular location or sub-sector, but also of national policies and regional arrangements. Some of these tools are listed in the following table:

Level	Tool
Macro-level country analysis	Drivers of Change (DFID) Strategic Governance and Corruption Analysis (SGACA, Netherlands) Power Analysis (Sida)
Sectoral Analysis	Analytical framework for Understanding the Political economy of Sectors and Policy Arenas (DFID/ODI) Addressing Governance in Sector Operations (EC)
Problem driven analysis	Political Economy of Policy Reform (World Bank SDD/OPM) Policymaking Process Framework (IADB) Problem-driven Governance and Political Economy Analysis (World Bank)

However, a word of caution needs to be injected in relation to these approaches. Firstly, these tools are general and not specifically adapted for business environment reform interventions. Secondly, and most importantly, analysis of the political economy environment is not a one-off exercise, but needs to be repeated regularly. A country's political economy is not static, and the issues that are identified at the beginning of a reform process will change and develop over time. Indeed, it is also true to say that a business environment reform process is itself part of the political economy. Reformers seek, over time to alter fundamental structures and processes in the host country. This is inevitably a political economy impact of the reform processes that development agencies and host governments put in place.

Implementation: some tools

There is no definitive list of tools and approaches that PSD practitioners can deploy to deal with the political economy issues that they face. The needs and therefore the relevant ways forward will vary country-by-country and would-be business environment reformers need to respond to the particular circumstances in which they find themselves. However, there are tools that others have found to be effective, and some of these are detailed below. What each PSD professional needs to do is to learn from these and develop their own repertoire to allow them to respond effectively to political economy challenges they face.

Generating political will

The political will to embark on and carry through business sector reforms is crucial. If there is sustained political resistance to reforms then they will either not happen, or disappear the day after

the donors do. However, whilst political indifference is unhelpful, so long as there is not outright resistance, donors and development agencies have some room for manoeuvre. BER often stalls because development practitioners view a particular BER as a means to serve the economic interests of the country as a whole, whereas for the politicians and senior civil servants necessary to make it happen, whether or not to push ahead with the reform depends on whether the reform serves their personal economic or political interest

Political commitment does not necessarily need to come from the very top. The support of junior Ministers or state governors can be sufficient. But the personal involvement of a country's leader can be crucial, as the experience of the World Bank-initiated Investor Councils demonstrates. These councils were established in several African countries with different results. In Senegal, the activity of the President in chairing Council meetings and holding press conferences was seen as a major reason why earlier progress was achieved there than in for example Ghana, where the President initially delegated the chair to another Minister.

Additionally, while personal commitment from senior government figures is important, outreach efforts that cause the public to look favourably on reform programmes can give individual politicians an incentive to be more enthusiastic and can minimise the effects of a change in government personnel. An effective outreach program can help to de-politicise the process by emphasising the practical benefits to people. If public opinion becomes generally supportive of the reform in question and sees it as genuinely aiming to advance the interests of society at large, politicians of all persuasions are less likely to seek to obstruct the process or allow it to lapse when power changes hands. For reform to be sustainable, it is important that all political groups are committed to the process and that the processes have a legal framework

Building coalitions of support

Support for business environment reforms is not inevitable. Although such reform may seem sensible and even desirable by outsiders, as has been seen there may be considerable domestic resistance. PSD practitioners therefore need to consider how the major players in the political economy can be persuaded to support business environment reforms. DFID's *Note on Political Economy Analysis* sets out a variety of ways on how to influence major players. Positive inducements include bringing together key players, such as the government, the donor community and the private sector, so that they can appreciate the benefits of co-operation; working closely with key players to understand their reluctance to change and to persuade them of the benefits of wider economic development; and developing an understanding of how key national players view aid, and how they believe it can be channelled to support business development.

Negative inducements include bringing home to reluctant key national players that if they do not entertain business enterprise reform then their power bases will be eroded by international

competition; redirecting aid away from programmes that key players will exploit for their own ends; and insisting on transparency in public communications, once a reform process is underway.

Timing and phasing of reforms

The sequencing of reforms can be critical to the chances of success: getting the timing and phasing of reforms correct can help to build support for the reform process and to win over potential opponents. In the post-Communist reform programmes in central Europe in the 1990s, an important early step in the sequence of transition reforms was to encourage the development of a small private sector prior to more comprehensive reforms. This meant that jobs were being created thereby reducing the fear of unemployment amongst workers. In Hungary, for example, the small private sector was already producing about 10 percent of industrial output by 1990. In privatisation programmes in this region, more profitable firms were privatised first in order to create political support and goodwill for further privatisation and other reforms. Less popular reforms were delayed, for example the restructuring and closing of loss-making enterprises. Gerard Roland speculates whether the reform programme in Russia might have been more successful if this phased approach had been used there: “one can wonder whether the adverse domestic reaction to price liberalisation in Russia in particular might not have been avoided if Russian reforms had first favoured the emergence of a small private industrial and service sector.”⁴²

The importance of Public-Private Dialogue

Public-Private Dialogue (PPD) is seen by many as a valuable tool in overcoming resistance to reform. PPD is in the operational front-line of the political economy approach, aimed at aligning interests amongst stakeholders through carefully planned and managed dialogue and advocacy. The World Bank, DFID and OECD together produced *Public Private Dialogue: A Toolkit for Business Environment Reformers* (2006), which argued that political economy changes were where PPD was most likely to have its most significant impact.

One review of PPD activities finds that that a key element of successful projects was the effort made to include powerful stakeholders, even those who at first were suspicious.⁴³ To combat the risks of cronyism and institutional capture, there needs to be an explicit commitment to transparency, and the incorporation into the PPD partnership of monitoring and accountability mechanisms. Failure to do this in Malaysia, where the government insisted on keeping off the table sensitive subjects such as privatisation and Malay ethnic domination of the civil service, led to a continuation of the perception of favouritism in the privatisation process.

It is also important to ensure that PPD mechanisms are not concentrated only at the top of organisations, or amongst an elite, but are open to a wider spectrum of voices. In Mexico at the end of the 1990s, the importance of political allegiance to the main party created tensions between the

⁴² Roland, G (2002) *The Political Economy of Transition*. William Davidson Working Paper no 413.

⁴³ Herzberg, B & Wright, A (2005), “Competitiveness partnerships— Building and maintaining public-private dialogue To improve the investment climate”, *DCED Conference Cairo 2005*

mass of entrepreneurs and the institutions supposed to represent them. PPD provided an opportunity for non-aligned chambers of commerce and business associations to launch initiatives that quickly acquired broad support, especially at the regional and state level. In Samoa, the Government currently provides annual grants to assist in meeting the costs of operating the secretariats of the Chamber of Commerce and the Manufacturers Association. In Vietnam the government helped by including associations in the PPD, creating an enabling regulatory framework in which they could operate, and delegating some tasks of SME assistance to them. The reform process in Sierra Leone demonstrates that capacity-building of business associations, especially those representing smaller enterprises, is crucial to building an inclusive process.

The greater and the more varied are the contributors and contributions to dialogues, the more successful they are. Trained facilitators help promote more balanced contributions, as occurred on the DFID project to support strengthening of the Chambers of Commerce in Donetsk and Luhansk in Ukraine. In the best PPD processes all parties feel motivated to contribute, and also feel that their contributions can make a difference.

Private Sector Development and Public Sector Reform

The whole thrust of the business environment policy is that the road to development lies through the private sector. However, as is apparent from the examples used earlier, a sclerotic or unskilled public sector can be a significant inhibitor to the growth of the private sector.

This implies therefore that public sector reform (PSR) needs to be looked at in a different way. Currently PSR is viewed by donors and development agencies as institutional strengthening to enable the better delivery of public services. But given that developing societies will only achieve economic growth through private sector development, one key aim of PSR could become that of enabling the private sector. There are a myriad ways in which this could be done, and be part of development projects, from de-regulation to public procurement.

Business environment reformers need to consider all the ways in which PSR projects could help the private sector. In Rwanda for example, programmes to reform the public sector, and improve its capability and efficiency, would have significant impacts on the business environment, in a number of ways. As noted earlier, the Rwanda Revenue Authority poses a significant challenge to many companies: working to reform it would yield immense benefits to the development of the private sector.

Stakeholder management

Careful management of different stakeholder groups is seen as an important tool to increase momentum for reform. The aim is not to build a broad consensus for reform including both winners and losers, but to build pro-reform coalitions that can move the process forward. These coalitions will change over time with new groups engaging. As IFC reports on the reform process in Vietnam: “a

dynamic strategy of stakeholder management was necessary to maintain a stable reform path as the participation of various stakeholders waxed and waned during the reform.”⁴⁴

Indeed, stakeholder management can sometimes mean setting up rivalries between different groups in order to create competition for reform. In Mexico for example during reforms in the early 2000s, rivalry between different States played an important role. According to IFC, a first reform programme in Puebla State had been successful in terms of reducing the amount of time needed to establish a business, in the numbers of new jobs created and in the number of new businesses opened or formalised. As a result of publicising this success, many of the other States and municipalities in Mexico approached the Government’s central reform commission to ask for support in implementing reforms in their own areas. “The creation of a positive rivalry among states and municipalities created the incentives to push ahead with reform”.⁴⁵

Local level strategies

As was made clear in the Uganda example, the political economy challenges to business environment reform may differ from region to region, and therefore PSD professionals need to consider local level as well as national strategies. For example, Hakemulder describes a project in Sri Lanka designed to enhance SME growth for poverty reduction by improving the sub-national business environment in the North-West and North-Central provinces.⁴⁶ At the District level, the project facilitated the establishment of SME Forums, which brought together representatives of the District Secretariat and Provincial Government, the private sector, and NGO and Government service providers. One problem was that the Forums did not have an official, legal status, which meant that their decisions were not binding. Their implementation depended on the authority of the District Secretary or Provincial authorities, and the goodwill of the NGOs and private sector organisations involved. So it was crucial that trust was built up through an approach that emphasised joint action. The project is now developing approaches to give SME associations a stronger voice at the District level, through the organisation of larger-scale dialogue events organised by the Forums.

⁴⁴ IFC (2009) *Lessons for Reformers: How to launch, implement and sustain regulatory reform* World Bank Group, Washington, p49

⁴⁵ *Ibid*, p64

⁴⁶ Hakemulder, R (2006), “Improving the local business environment through dialogue; a story from Sri Lanka” DCED Asia Consultative Conference ‘Creating Better Business Environments for Enterprise Development’, Bangkok, 2006.

4: Field-craft

Neither on their own or collectively are the tools outlined in the previous chapter the answer to successfully navigating the pitfalls of political economy. PSD professionals need to develop their own ability to understand and manage these issues as an integral part of their job. The previous chapter defined some useful tools: this one describes what one might term the 'field-craft' required to successfully manage political economy issues.

Talk to specialists in other disciplines

PSD does not exist in isolation. Many of the challenges faced by PSD practitioners are also faced by those working in other areas of development programming. In Bosnia for example, the problems in the business environment reflect those at a wider constitutional level. PSD professionals therefore need to work closely with their colleagues in other areas. Those working on constitutional reform, democratisation, rule of law and other similar areas will be able to offer significant insights to guide reform of the business environment. In some cases it may be appropriate to work closely together with colleagues working on these issues.

Use the business environment itself as a diagnostic

The problems in a particular country's business environment are not random: they reflect the local history and circumstances. Therefore an assessment of what reform is needed of a country's business environment can also be used as an assessment of the political economy. PSD practitioners need not just to ask what is wrong with a country's business environment, but also why it is wrong, and how it got to be that way. In Bosnia for example, the complexity of the business environment reflects the complexity of the Dayton structures.

Observe and listen

Tools such as those designed to facilitate analysis of the political economy are only as good as the ability of practitioners to use them effectively. PSD practitioners need to develop the habit of observation and listening. The best way to begin to understand a country and its political economy is to get out there and talk to people. It is very easy to get into a habit of talking always to the same few people. Extending the network of those whose insights and views are taken into account can greatly assist in developing an understanding of the host country and of the political economy challenges and how they might hinder or shape efforts at business environment reform. The WBG has a collaboration space available for its officers to share their experiences.

The need for continual evaluation

Analysis and evaluation of the basis for a business environment reform is not a one-off exercise, but a continual process. Too often, an initial analysis is performed as part of project inception, but no follow up is undertaken. Analysis of a country's political economy is not an episode, but rather needs to be an on-going process. There needs to be a clear hypothesis of what trajectory is expected, and

mapping of forthcoming events – elections for example – that will have a material bearing on that hypothesis.

Develop a network

Over time, it is necessary to develop a network of people who will be able to provide an on-going insight into what is going on in a country. As a rule of thumb, development practitioners who spend too much time in the office, or in only speaking with the same small network of people are not doing their job properly. It is important to develop and expand a network of contacts who are able to provide different perspectives on the wider situation in a country, and on how this changes over time.

Remember the art of the possible

However important PSD and business environment reform might be, it is only one element of a wider reform agenda and as such is dependent on this wider perspective. PSD professionals therefore need to be sanguine about what they can – and cannot – realistically achieve. In Azerbaijan for example, a considerable impediment to development of the private sector is the high degree of corruption. However, on their own, there is little that business environment reformers can do to address this issue. Tackling corruption is something that needs to be tackled at a governmental level. It is a matter of diplomacy, not PSD to address issues of corruption and the absence of thorough-going reform in Azerbaijan.

That said, it is important that, where issues come to light which affect on business environment reform, but whose solution needs co-ordinated effort, that PSD professionals work with and lobby their colleagues and the host government to develop coherent strategies.

Rotation of staff

Many donor agencies have a policy of rotating staff into new jobs every 2-3 years. This approach has damaging effects for the ability of agencies to develop and maintain a clear understanding of the political economy of the countries where they operate. It is only after two years or so that an individual will be developing a sophisticated understanding of the country where they are based. However, if regular turnover of staff is inevitable, then agencies need to ensure that hand-over procedures are as comprehensive as possible.

5: Typology of issues and potential responses

As has been stressed throughout this paper, political economy is a complex subject that encompasses a wide range of issues, and moreover issues that vary from country to country, and over time. Although, as the previous sections have sought to demonstrate, there are tools, approaches and ways of working which can help business environment reformers understand and overcome political economy challenges, there can be no blueprints or templates for action which are universally applicable or which come with guaranteed success. However, what this chapter does is attempt to detail some typical political economy issues and, drawing on the previous two chapters, the tables at the end set out how reformers might go about addressing these challenges.

Corruption

Campaign group Transparency International defines corruption as “the abuse of entrusted power for private gain.” However, this simple word masks a highly diverse set of behaviours ranging from venality at one extreme, to necessity at the other.

The corruption that is most often in the public eye is the kleptocratic use of power by country elites to enrich themselves – for example by the exploitation of natural resources – at the expense of the country at large. Indeed, the Extractive Industries Transparency Initiative was established to address an aspect of this problem: payments of revenues in relation to oil, gas and mineral extraction being made to individual ministers or officials rather than the state treasury.

However corruption, albeit at a financially-smaller level, can as easily be driven by necessity as by greed. In many countries officials are so poorly paid that they are unable to earn a living wage from their salary alone. Middle-ranking and junior officials may be obliged, by sheer economic necessity, to request and take bribes. Tackling corruption therefore requires an understanding of what drives it in different situations, and business environment reformers need to understand the impacts of corrupt practices on their proposed reforms.

Corruption also varies in how it is transacted. The proverbial brown envelope full of cash is not the only way in which bribes get paid. Lavish entertainment and gifts, or expenses-paid excursions can also be vehicles for corrupt payments to be made. Reformers need to understand the processes by which bribery occurs in the country where they are working if they are to seek to address the problem.

Problems of leadership

Active support from senior politicians and officials is very important if thorough-going and durable reform is to be achieved. Yet in many situations, this leadership may not be forthcoming or, even more problematic, a country's political elite may actively obstruct reform.

Reformers tend to regard improvements to the business environment as self-evident goods, but local political leaders may not take the same view. Reforms will necessarily change the way in which things happen, and this may not be seen as desirable to some officials or politicians. This might be because they are familiar and comfortable with the way things are currently done; they may have a vested financial interest in current structures; or maybe they believe that they might lose their job were proposed reforms to be introduced.

However, it may be that political leaders or some officials really do want reform to occur, but they lack the authority or capacity to make things happen. Again, the reasons for this could be many, but might include, for example that the minister responsible for business environment reform is relatively junior and lacks 'clout' with his colleagues with the result that their priorities take precedence. However, it may also be that national government structures lack reach into the country as a whole, perhaps because of communications difficulties, or because of the existence of powerful regional or local government structures.

Ruling elites: familial, tribal and clan relationships

Genuine democracies, or countries in which power transfers between different groups over time are rare. In many countries, political power lies with a particular groups or elites. Often these groups are connected by clan or tribal relationships with key political figures and officials linked by loyalty to their family group. Their loyalty will usually be to that group rather than the state as a whole. Indeed, their aim in government may be to further the interests of their clan or tribe relative to others in the country. Often conflict or political change is driven by rivalries between different tribal or clan groupings, for example the violence surrounding the elections in Kenya in 2009.

This type of rule by elites is problematic in a number of ways. Most obvious is that it is inherently unstable since it excludes large numbers of people from involvement in the government. Those excluded from power, or who believe that their interests are being damaged by the government may be inclined to act violently in an effort to make their voice heard. The work of Paul Collier and Anke Hoeffler into the causes of civil war is particularly instructive in this regard, making it clear that countries where wealth is concentrated into the hands of the few are more likely to descend into conflict.

Moreover, government is run for the benefit of one group within society, not the country as a whole. Decisions will be made on factional, not national interest. For those seeking to effect, for example, business environment reform, the challenge may be that reforms which are in the interest of the country as a whole may be obstructed if they are perceived to run counter to the interests of the ruling group. Market liberalisation for instance may well be extremely problematic since it seeks to open the economy up, a process that is likely to run counter to the vested interests of the ruling elite.

States ruled by elite groups are often also highly inefficient because officials are not appointed based on their ability to carry out the formal job description, but because of their loyalty to the ruling clique. This issue will be discussed further in the next section.

State capture

The previous section dealt with the challenge of a political class that holds political power in a country to the exclusion of others. The problem can equally be with powerful interest groups outside government having undue influence on the country and therefore the ability to block reforms that they perceive to run counter to their interests. There may for example be a powerful set of companies which act in concert to control markets and exert their will on government. It may also be an entity such as the military which constrains government from acting in a way that works in the benefit of the country as a whole, rather than for a particular interest group.

In such circumstances, the capacity of a government to act can be seriously constrained since, in a very practical way, its writ does not run throughout the country. The government's latitude to reform and make changes is limited by the desires and aims of the interest group or groups. In such circumstances, reformers find themselves in the situation where dealing only with the government and officials is not sufficient to effect change. On the other hand, is it feasible or legitimate to deal with non-governmental interest groups?

Challenges of competences and skills

It is not unusual to find a country in which either political leaders or the government functionaries responsible for overseeing business environment reform lack the competencies or skills to do their jobs properly. There may be a number of reasons for this. Most obviously the problem might stem from the impact of a poor education system; perhaps where few people go on to tertiary or even secondary education. Equally the problem may be the result of an education system that is still predicated on a previous economic or political model – many former Communist countries for example still have education systems designed for the needs of their former political structure. Wars and disease can also have significant impacts on the skills levels in government, both by reducing the number of skilled people available, and disrupting education of others. As a result, the trained, professional class of people needed for effective government is small.

However, the type of nepotistic rule by a small elite can also have impacts on competencies and skills of key ministers and officials. In countries of this type appointments are made on the basis of ethnicity, clan, or on the individual's loyalty to a particular group or leader, rather than on the basis of their skills, training or capacity for the job.

Obviously such deficiencies present a significant challenge to business environment reformers since many of their local counterparts may not readily understand, or be able to put into practice, the changes required. Even in situations where a well-qualified administrative cadre exists, it may be that

their training and experience is ill-matched for the challenges they face. Reformers working in Central and Eastern Europe the 1990s found that, although a good education system existed, it was predicated on the need to train administrators of a Communist system.

Official structures versus reality

In many countries, there is a significant gap between the official structures and processes in place through which government business is meant to be transacted, and the reality of how things actually happen. Business environment reformers need to be aware of the reality, and that things sometimes happen through unofficial channels. Perhaps inevitably, there are many reasons why this might be.

One explanation is that formal regulatory and legal processes have been introduced in places where there exist long-established local cultural norms for getting things done. Governmental administrative systems make sense as a *modus operandi* for those of us for whom they are normal, but in many developing countries 'normal' processes are those tribal, regional or other structures that have existed for a long time; which people trust; and which they know to work. In such circumstances, people may go through the motions of adhering to the 'official' process, but will do so as only as a veneer: they ways things actually operate will be through traditional systems.

However it may be that a gap between official process and actual practice is the result of a lack of follow-up in ensuring that official regulations are actually adhered too. With health and safety for example, it is not unusual to have countries where the regulatory framework very adequately meets scrutiny, but where little effort is made in actually implementing these statutes. Resources given to enforcement processes may be insufficient to ensure that the regulations are actually enacted, with the result that real practice will be far from that stipulated by the official process.

Gaps between the official and the actual might also occur because the writ of the central government does not run in all parts of the country. It may be that the central authorities are making efforts to implement coherent programmes, but they are unable to do so consistently through the country. This could be a function of communications links, or a reflection of the existence of strong local or regional authorities which resist what they see as central government edict.

In any of the above cases, the art for the business environment reformer is to understand how things actually operate in a country and to ascertain whether or not this seems to reflect official practice. There is little point in reforming the business environment if the regulations being reformed do not, in reality, guide what happens in real life.

Issue	Analysis: issues to consider	Tools: Ideas on addressing the challenge
Corruption	<ul style="list-style-type: none"> • Is corruption driven by greed or necessity? • How does corruption occur – how are corrupt payments made? • How far is such practice seen as acceptable, or are local groups and individuals already seeking to address corruption? • How pervasive is the problem: is it widespread, or limited to particular regions, or functions? 	<ul style="list-style-type: none"> • Can need-driven corruption be addressed through changes to wage rates? • Consider a media campaign demonstrating the negative social impact of corruption • Develop a group of other stakeholders to ‘point the finger’ at corrupt practice. • Work with existing anti-corruption initiatives such as the Extractive Industries Transparency Initiative, or with local chapters of organisations such as Transparency International
Problems of leadership	<ul style="list-style-type: none"> • Are leaders weak? <ul style="list-style-type: none"> • If so, why? • Are leaders unwilling to push forward reform? <ul style="list-style-type: none"> • What vested interest is causing this reluctance for reform? • Do leaders properly understand the benefits of reform, and the potential risks of inaction? 	<ul style="list-style-type: none"> • Identify and work with politicians and officials who are advocates for reform • Re-configure reforms in a way that is less threatening to vested interests. • Lead reform programmes with measures that will quickly demonstrate wider benefit, so building wider support for further reform. • Identify ways of providing support to those who advocate reform, perhaps through media campaigns.
Ruling elites	<ul style="list-style-type: none"> • Is the Government of the country ethnically and religiously diverse, or is it drawn from a narrow group? • If the latter, then what is the nature of the connection between key politicians and officials? • What implications does this have for the potential for business environment reform? • What tensions exist within this group? • How might their interests be served by reform? 	<ul style="list-style-type: none"> • Consider sequencing reforms in a way that does not challenge the dominance of the ruling group, and demonstrates how they might benefit from further reform • Identify motivations of the ruling elite that might be consistent with a reform programme, for example a desire to look good on the world stage • Identify and mobilise other stakeholders – civil society groups, chambers of commerce, etc – who are also seeking to press forward with reform.

Issue	Analysis: issues to consider	Tools: Ideas on addressing the challenge
State capture	<ul style="list-style-type: none"> • What is the nature of the group exerting undue control? • How is that control exerted: is it through the actual or threatened use of force, or through more subtle means? • How unified is the group: is there potential for demonstrating that elements of the group may benefit from reform? • What is the geographic or functional extent of the group's reach? 	<ul style="list-style-type: none"> • Begin reform processes in regions outside the group's control, so demonstrating the rationale for, and benefits of reform. • Identify and begin with reforms that will be in the interest of the dominant group • Identify and work with other stakeholders who are also promoting the need for reform. Such coalitions can sometimes prove to be more powerful than the entrenched interest group. • Identify media that may be relevant to reach the group in different ways.
Skills and capacity	<ul style="list-style-type: none"> • What skills and capacities are lacking? • Is the problem widespread, or does it occur only in certain parts of government or certain regions? • In what ways does the skills deficit cause problems for reform programmes? • What is the underlying cause of the problem – for example the result of poor education levels in the country as a whole? • How does the problem affect other aspects of government? 	<ul style="list-style-type: none"> • Consider starting reforms in a particular area where sufficient skilled staff are available in the administration. • Create training programmes to foster and develop relevant skills and capabilities. • Understand and work with other initiatives that are working to develop the country's skills base, and ensure that the needs of business environment reform are reflected in these.
Official structures vs. reality	<ul style="list-style-type: none"> • What evidence is there that official processes and structures are actually reflected in practice on the ground? • Is adequate resource given to implementation of government processes and systems? 	<ul style="list-style-type: none"> • Ensure that reform programmes take account of the reality of practice on the ground, not just 'official' systems. • Vary the reform process to reflect different realities 'on-the-ground'. • Ensure that adequate resource is made available to ensuring that reforms are implemented.

6: Conclusions

What this short paper has sought to demonstrate is that effective business environment reform cannot be achieved without understanding and responding to the political economy issues that each country presents. Modernising business regulation, cutting red tape and other such activities are not economic tasks dissociated from the wider political, social and cultural environment. Nor are they a *priori* goods. It may appear to us that reform of the business environment is inherently a good thing, but not everyone agrees. In fact, these activities are highly political acts which alter the *status quo* and, sometimes, undermine entrenched interests and long-established local norms. Certainly there will be constituencies which whole-heartedly welcome business environment reform, but others will see it as detrimental to their position and will resist. Key elements of the art of managing the political economy implications to business environment reform are to identify who are the allies and opponents; how to mobilise the former; and to win the latter round.

Nor can this paper – or indeed even a paper many times its length – provide details of all the political economy issues that business environment reformers may face, or the tools they might deploy to address them. Section 1 of this report profiled a number of countries to provide illustrations of the sorts of issues which arise, but this is not a comprehensive list. Some of the approaches which have been successful in the past were profiled in section 3: but readers of this report need to explore, with their colleagues and in the literature, what other tools may be available to tackle the specific issues that they face.

Understanding a country's political economy, and navigating business environment reforms through the complexity that it presents is an art, not a science. It is unrealistic – even dangerous – to expect there to be a checklist whose completion would guarantee that political economy issues had been properly addressed. However, this is not to say that the political economy impacts on reform programmes do not need to be systematically addressed. Analysis of what the challenges are needs to be rigorous and repeated, and the impacts of the key issues on reform programmes need to be managed assiduously.

Therefore it is the recommendations in section 4 of this report which are arguably the most important since they address the ways of working, and practical approaches to the task of reform which optimises the chance of dealing effectively with the issues of political economy. A PSD advisor who spends most of their time in their own office is unlikely to be good at tackling political economy issues. Conversely, one who is constantly talking to new people in an effort to form and challenge hypotheses about how the host country operates is likely to be much more successful. Tapping into the tremendous resource that PSD professionals have in their colleagues in other parts of their organisations is also vital. There can be no guarantees about steering reform programmes around political economy challenges, but approaches like these certainly maximise the chances of succeeding in doing so.

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