

Department of Economics Inaugural Lecture



Department
of Economics

Political Economy and Development: a progress report

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The Political Economy of Development: A Progress Report

Inaugural W. Arthur Lewis Lecture



W. Arthur Lewis (1915-1991)



This Lecture

- A subjective assessment of political economy in development
 - a special focus on how the emergence of the field of political economy has changed the way that we think about development policy/problems
- This provides a case study of how thinking in a discipline can change profoundly over a generation
 - The economics I was taught had little or no mention of political economy.
 - And almost all the ideas and developments that I will discuss have taken place in the “post-Lewis” era.

Roadmap

1. Reflect on the fall and rise of development economics within mainstream economics
2. Discuss the field of political economy and its rise in mainstream economics
3. Look at three specific “case studies” where taking a political economy perspective is important

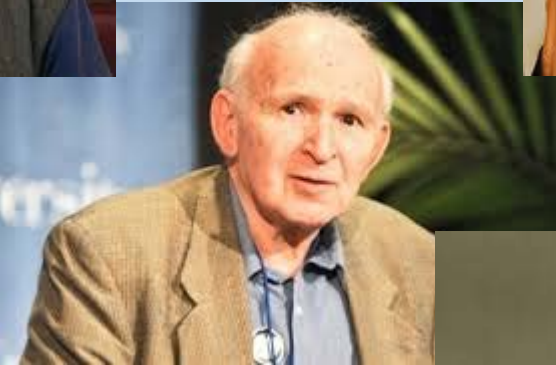
The Fall and Rise of Development Economics

- The field of development has had a patchy history within mainstream economics
- Lewis was a Nobel laureate (1979) so hard to argue that his work was not valued by (at least some of) those whose opinion counts
- BUT the field was fragmented in a variety of ways
 - The nature of dualism
 - Did studying development require a distinctive kind of economics?
 - For a long period many top departments in economics had few economists who would self-identify as development economists

Themes

- Structural dualism
 - Economies looked different suggesting that aggregate growth models could be of limited relevance
 - Importance of agriculture and other “traditional” sectors with distinctive institutional arrangements
- The Policy Challenges
 - Changing the distribution of capital
 - Role of multilateral institutions and aid
 - Economists providing the architecture for economic policy
 - Cost benefit analysis
 - Policies to “correct” market failures

Some of the Players



Progress in Development

- Infant industry arguments and knowledge spillovers
 - The case for active trade policy
- Bringing in micro-data
 - Particularly on households
 - Collection of bespoke data
- Understanding household behaviour
 - Collective choice
 - Production and consumption decisions
- Understanding frictions which cause inefficiencies
 - Micro-institutions
 - Understanding constraints which affect contractual forms
 - Interdependent inefficiencies
 - Inefficient markets can compound contractual inefficiencies?

Benevolent Policy Design

- A stylized representation would go as follows
 - Identify specific types of market and institutional imperfections
 - Design interventions which respond to these
 - Collect the information needed to design policy
 - Work with government on policy implementation
- This stylized view corresponds to a powerful and influential tradition in economic policy analysis
 - Key figures include: Pigou, Meade and Mirrlees

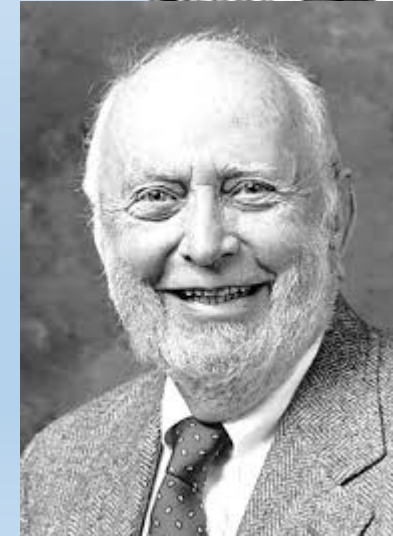
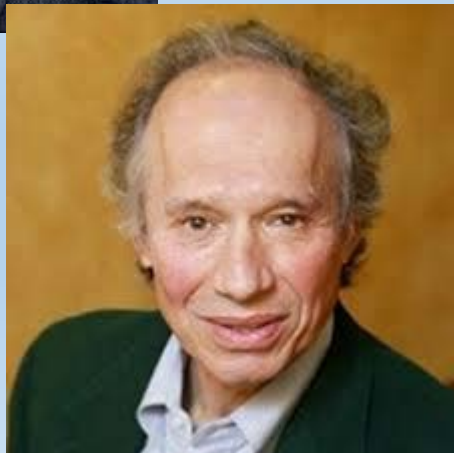
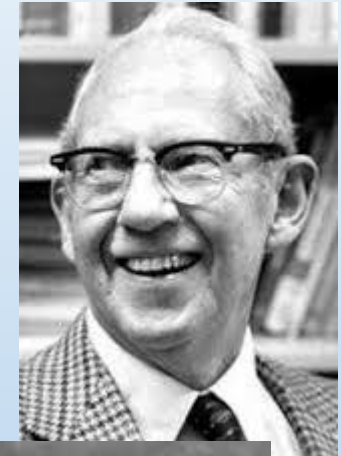
Losing the Faith?

- How does one square the above view with the observation that much government intervention does not go follow the model above?
 - Powerful examples
 - Evidence of corruption and rent-seeking
 - The economic traumas in rich countries in the 1970s
 - Watchwords “government failure” begin to appear along side “market failure”
- So what explains the performance of government?
 - When does it get interventions right and when does it get them wrong?
- Answering this needed a new body of knowledge
 - Or did it?

Whither Political Economy?

- Has had a patchy history in relation to mainstream economic thinking
 - The term is confusing as it had meant all of economics for some earlier thinkers
 - But for around a century mainstream economics pursued a divorce from other social sciences
- Even so, there were two distinctive movements within economics
 - Virginia School (Buchanan and Tullock)
 - Chicago School (Becker/Peltzman/Stigler)
- But little overlap with development thinking.
 - Exceptions include Bhagwati and Krueger

Pioneers in Political Economy



Whither Political Economy?

- Both Virginia and Chicago Political Economy were generally more cautious about government intervention
 - At the least it was necessary to understand the distortions
 - Log-rolling
 - Regulatory capture
 - Pressure group influence
 - The Virginia school opened debates about different political institutions worked and influenced the nature of “distortions” and extent of government failure.
- But most of the work was confined to unpacking the problems of the advanced democracies

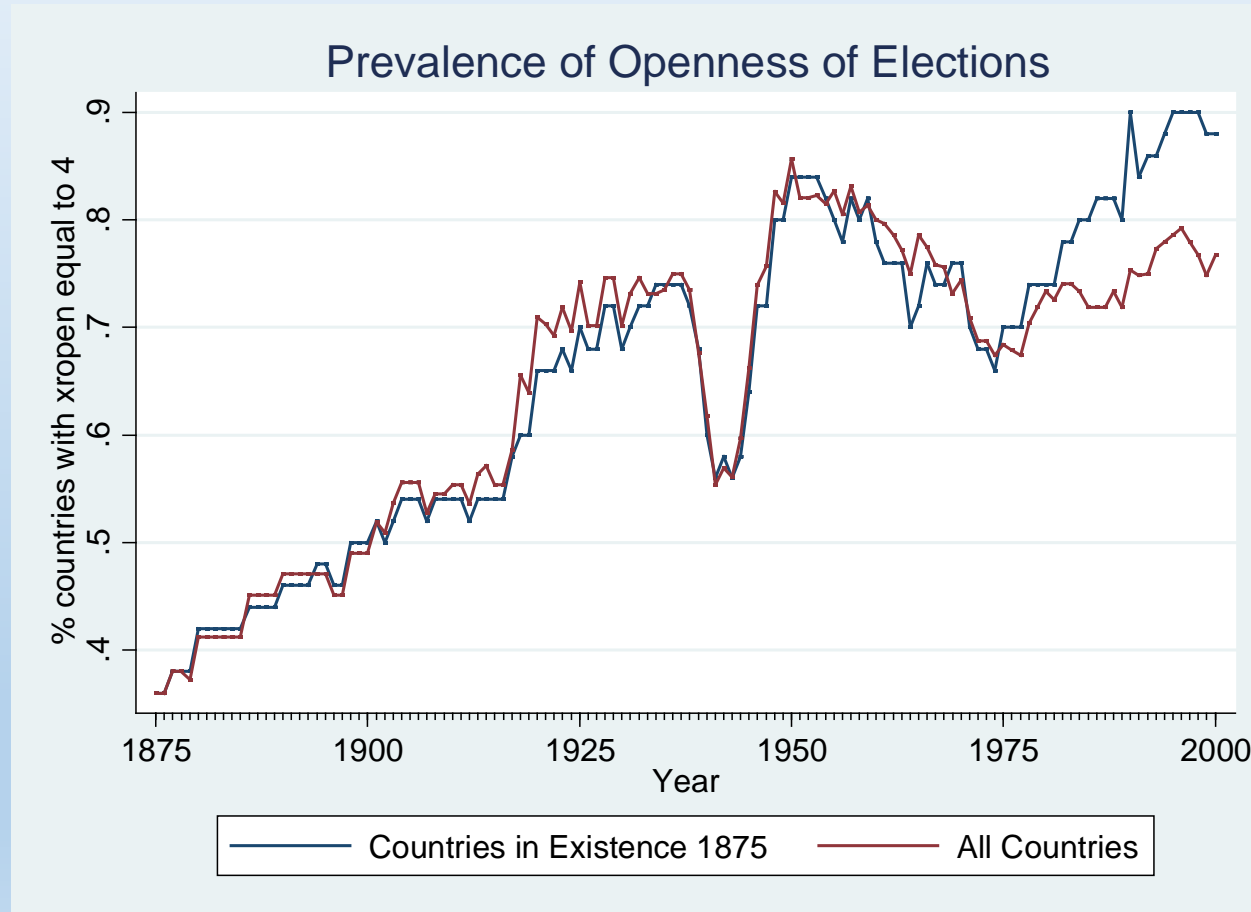
Why might political institutions matter for long-run prosperity?

- Institutions can influence investment incentives
 - Long-standing interest in enforcement of property rights
 - Can the state make credible policy commitments?
 - Played a central role in the thinking of Douglass North
 - Does the state take a long-run perspective in designing infrastructure strategies?
- Institutions affect distribution and redistribution
 - How do ruling groups behave?
 - This has a bearing on the nature of conflict and whether this spills over into violence
 - Civil conflict and its determinants is now a major theme in the literature

Political Development: The Big Picture

- There are data sets which (imperfectly) allow us to look at patterns of institutional development over fairly long periods of time
- There are two key dimensions to this
 - Openness of access to power
 - Constraints over the use of power
- People frequently look at a composite of these and call it “democracy”
 - But I doubt the wisdom of this:
 - *mea culpa*

Openness



Executive Constraints

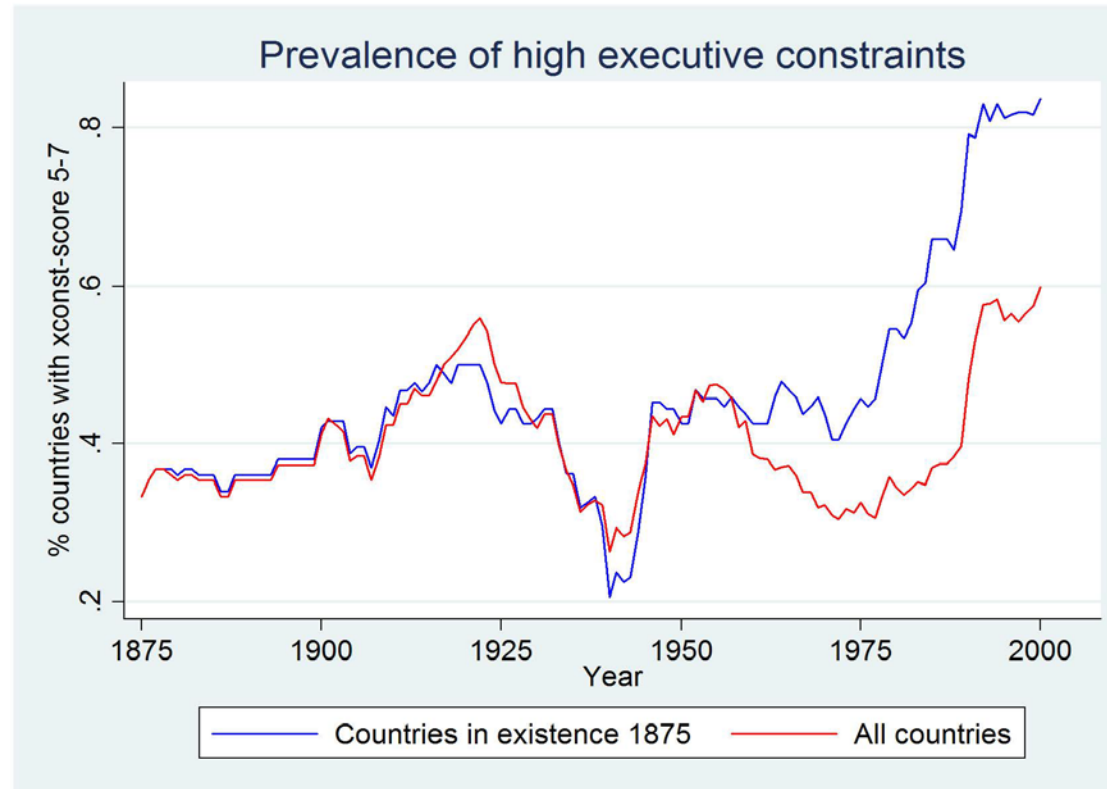


Figure 1 - Cohesive institutions worldwide, 1874-2004

Big Questions in the Political Economy of Development

- Does the pattern of economic change echo the pattern of political change in any interesting way?
- If so, could one use this to think about priorities for political reform?
- Can we then say anything about where institutional reform comes from?
- What evidence can we bring to bear to encourage an “evidence-based” approach to the debate?
- Does theory help? If so, how?

An Overarching Challenge

- Looking across countries and over time, there is a complex web of multi-directional causality
- It does not make a lot of sense to ask whether politics causes economics or vice versa
 - This lack of clarity is off-putting to some who wish to trade only in simple stories of unidirectional causality
- Much more sensible to look at what lessons can be drawn from specific sources of evidence which are joined into a complete narrative via models
 - Arguably that was what Arthur Lewis was doing in his classic foundational paper on development.

How to Make Progress?

- Need to unpack the constellation of specific arrangements which underlie these aggregate indicators
 - Requires us to “drill down” understand how institutional arrangements work “on the ground” with a view to building up the bigger picture.
 - This exercise naturally joins micro and macro aspects of political economy
- To do this, we need to get specific about the arrangements
 - Rules that govern institutions
 - But also informal norms and practices which shape behaviour
- Will next discuss this in general and then discuss some places where insights have been generated for development paths

Partners in Crime



Political Economy in General

- How do institutions resolve conflicts of interest and promote common interests?
 - Rich versus poor
 - Gender relations
 - New versus old production sectors
 - Ethnic groups
- Incentives and Selection in Institution design
 - Electoral systems
 - Legislative organization
 - Political reservation
 - Legal and regulatory systems
 - Effective state bureaucracies

Political Economy in General

- How can institutions be designed to deal with short-termism and time-consistency?
 - The role of accountable but independent institutions
 - E.g. Central Banks, Regulators
- How to achieve transparency and accountability?
 - Role of media watchdogs
 - Constitutional provisions
- Where should the locus of power reside?
 - What role for
 - Local
 - Regional
 - Supranational governance

Political Economy

- The literature that has developed in the past 25 years has created a tool kit for looking at many of these issues
- And it has created empirical knowledge in specific contexts
 - Examples
 - Political competition can affect incentives and selection
 - Term limits can affect incentives
 - Reservation of seats can change policy outcomes
 - There are jurisdictional spillovers in policy choices
 - Presidential and parliamentary systems have different policy outcomes
 - Auditing politicians can affect the level of corruption

Political Economy in Development

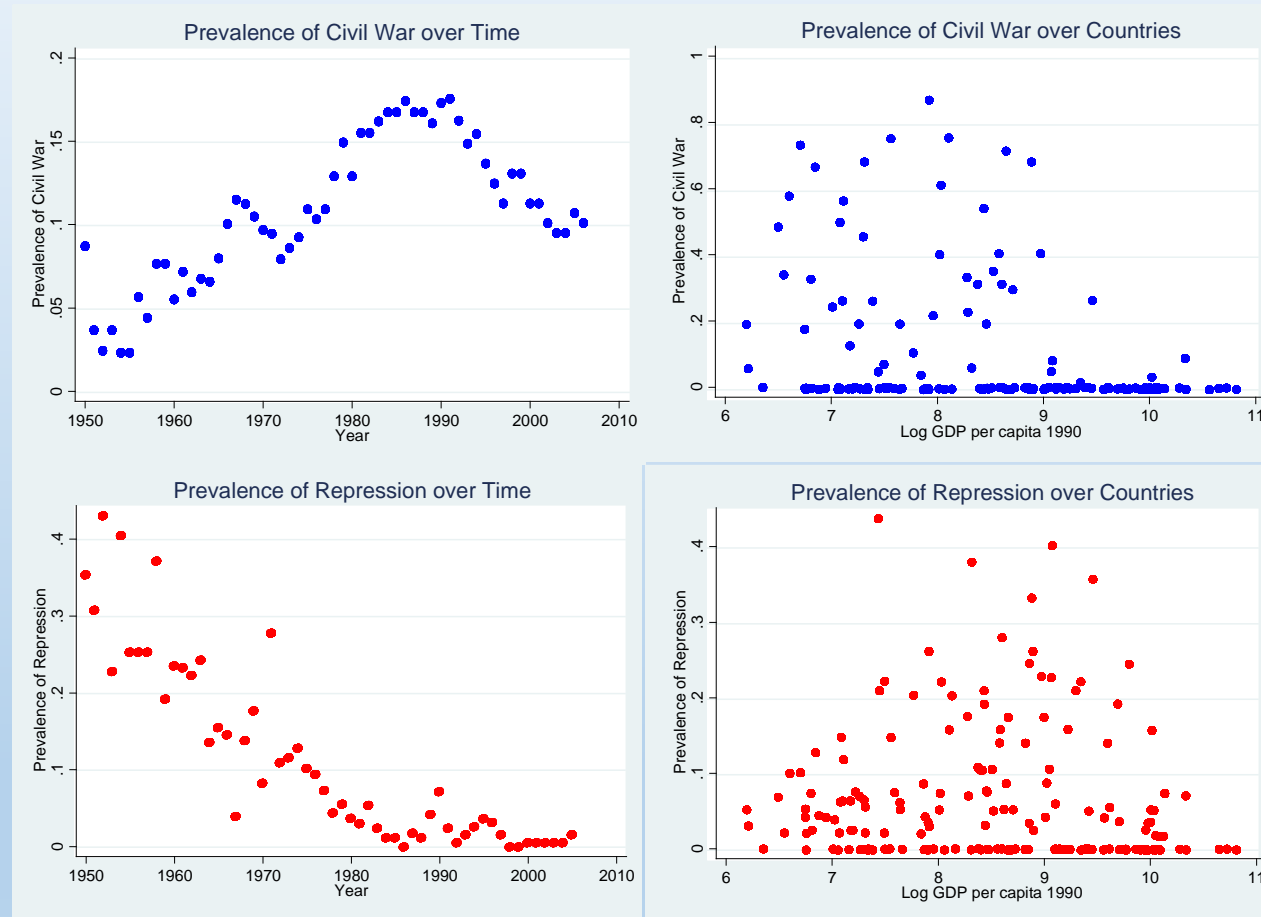
- I will development three “case studies” to illustrate where progress in political economy has gone hand-in-hand with a better understanding of the development process
 - The study of conflict and violence
 - Debates about development and institutions
 - Political institutions and robust control
- In each I will draw out from these three examples why executive constraints matter to understanding these
 - Perhaps more than studying openness/elections

Case Study 1

Conflict and Political Violence

- This has become a particular focus of the work in development
 - The study of conflict among economists was almost non-existent 20 years ago
 - There has been a particular focus on intra-state conflict
 - A whole range of measurement issues surround this
 - But there are now many commonly used sources of data
- It is an interesting area for those who are interested in development as conflict is most prevalent in low income countries
 - Moreover, there are also strong correlations with weak executive constraints
- The agenda that has looked at conflict has rarely been joined up to wider political economy issues
 - Alternative to conflict could be “true” peace or repression

The Logic of Political Violence



The Logic of Political Violence

- Investments in violence can be viewed as forward-looking and strategic.
 - These investments affect the probability that a ruling group stays in power or loses power.
- Three states of violence can emerge
 - Peace
 - Neither the government nor any opposition group chooses to invest in violence.
 - Benefits to capturing the state are small relative to the cost of fighting.
 - Repression
 - The state chooses to use its comparative advantage in violence to establish and maintain its hold on power.
 - Tends to occur in countries with non-cohesive political institutions, but an effective military or an opposition that is relatively fragmented or poorly organized.
 - Civil war
 - More than one group, including the government, takes to violence
 - Organized opposition/low opportunity costs

Why Political Institutions Matter?

- Affect how spoils from holding office are divided?
 - Broad-based coalitions versus “winner-takes-all”
 - Role of robust legal institutions in protecting groups
 - Strong executive constraints make conflict less likely?
- Entrenchment
 - How likely are peaceful transitions from power?
 - Can increased openness increase chances of repression?
- Of course, it is necessary to look in detail country circumstances, but understanding the politics is key.

Case Study 2

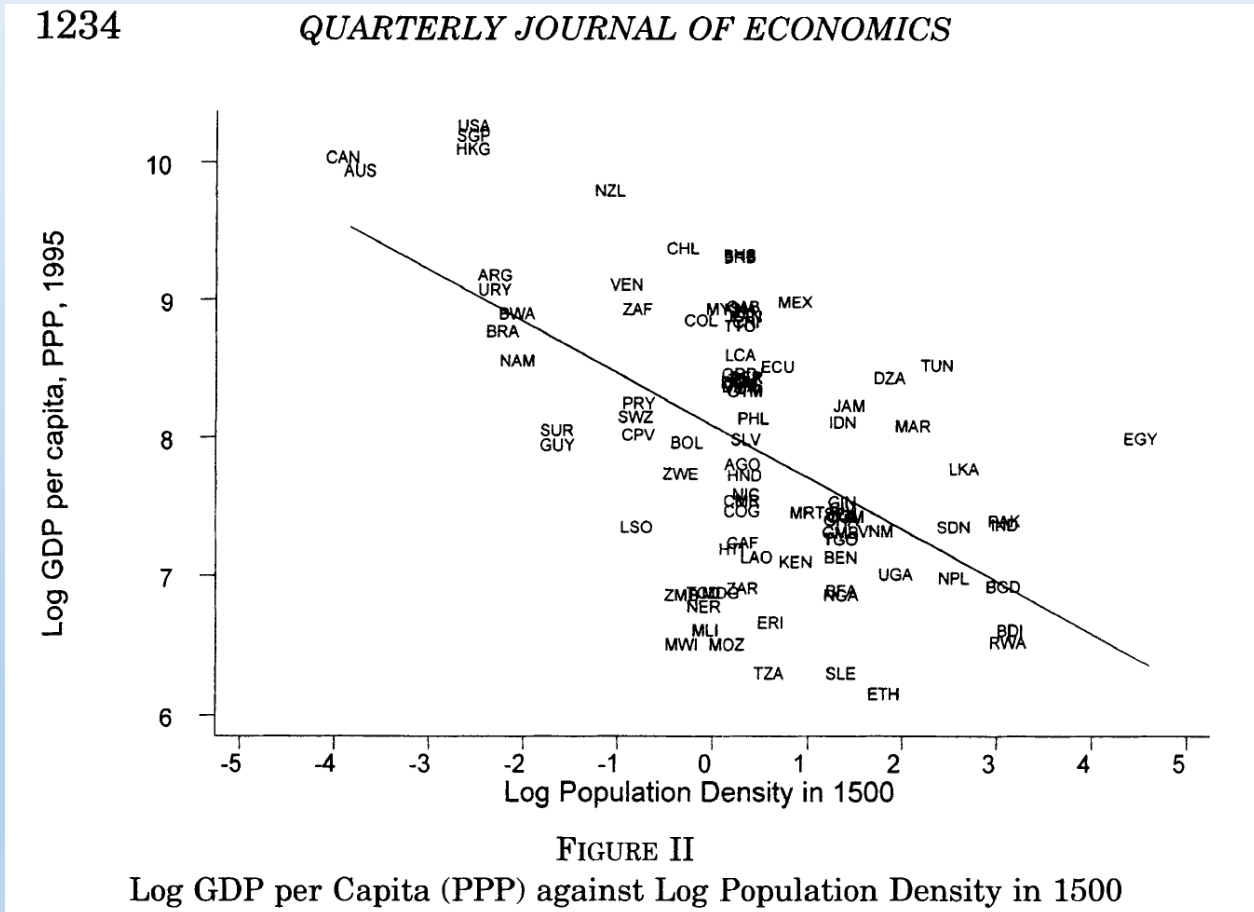
Development and Institutions

- An extremely influential line of thinking has come from the work of Acemoglu, Johnson and Robinson
- Built on two powerful correlations
 - Settler mortality and patterns of modern development
 - With settler mortality being correlated with measures of expropriation risk
 - Low population density colonies (measured c 1500) enjoyed more subsequent economic success
- Their work focused the mind on two things
 - Institutions affecting core economic incentives
 - Importance of long-run influence coming via institutional persistence
- Big message: creating inclusive rather extractive institutions is what matters!
- And this has created a whole quantitative literature on historical persistence
 - Natural experiments in history

Kindred Spirits



Reversal of Fortune



Natural Experiments in History

(Examples)

- Parts of Africa that experienced slavery more intensively are poorer today and respondents to questionnaires show less trust
- Areas of Africa which were more conflict prone before colonialism also have more conflict in the post-colonial period
- There is greater conflict in parts of Africa where ethnic groups were partitioned by colonialism
- Colonial institutions for land administration in India are correlated with modern day productivity

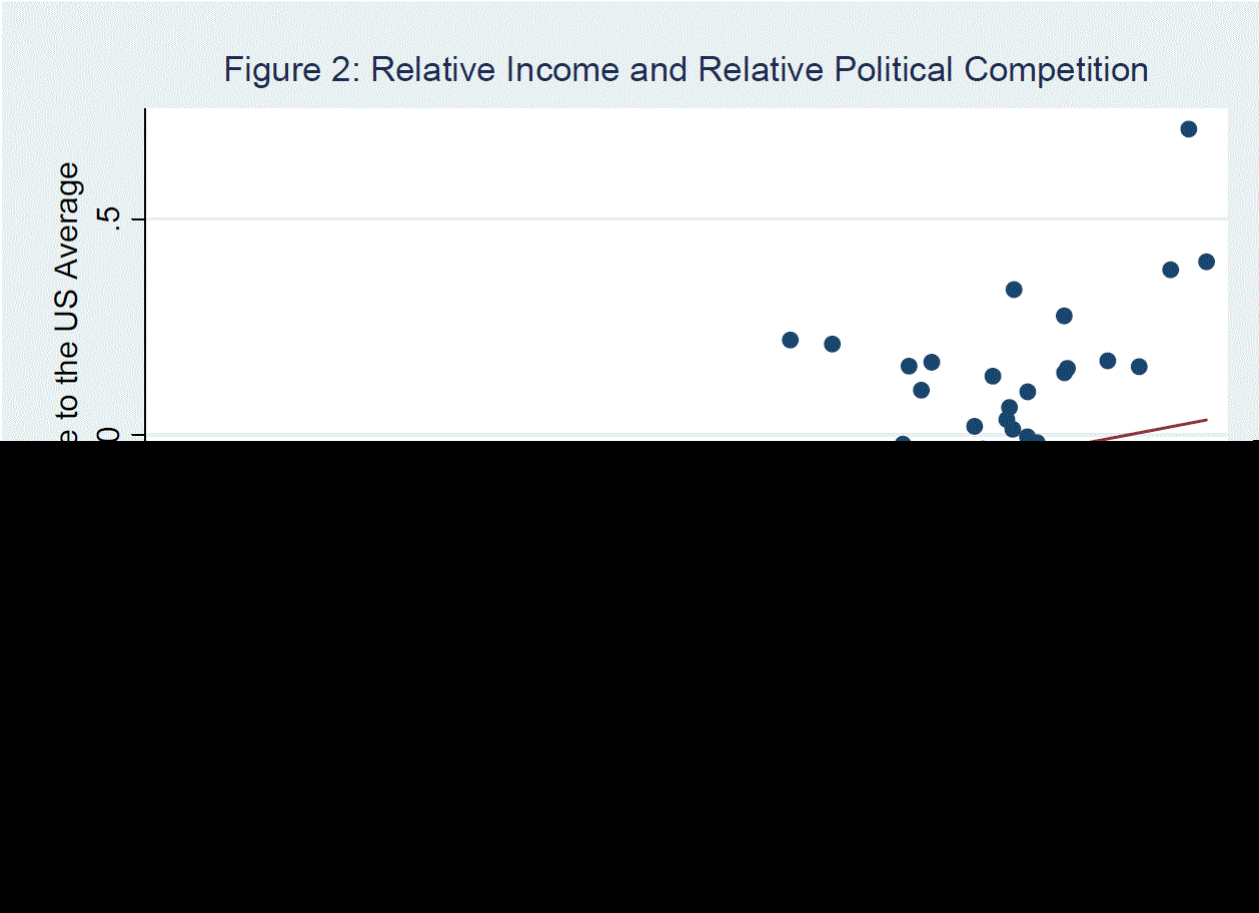
The Puzzle of Persistence

- One of the main challenges is to understand how things persist for so long.
 - Why don't institutional arrangements change if there are beneficial consequences of them doing so?
- We are only just beginning to develop coherent theories of institutional change
 - Also accounts of heterogeneous performance of institutions in different contexts
- Possible sources:
 - Persistence of power and elites
 - Institutions lead to irreversible or slowly depreciating investments
 - “Lock-in” via norms and cultural features

Persistence of Power and Elites

- Example of US South
 - Basic formal institutions looked similar to the north after civil war
 - Elites could capture political institutions
 - But large de facto differences with consequences for economic development
 - Led to virtual political monopoly in most states
- Change was due to
 - Federal intervention via supreme court intervention civil rights act and supreme court judgements
 - Had profound effects on economic policy

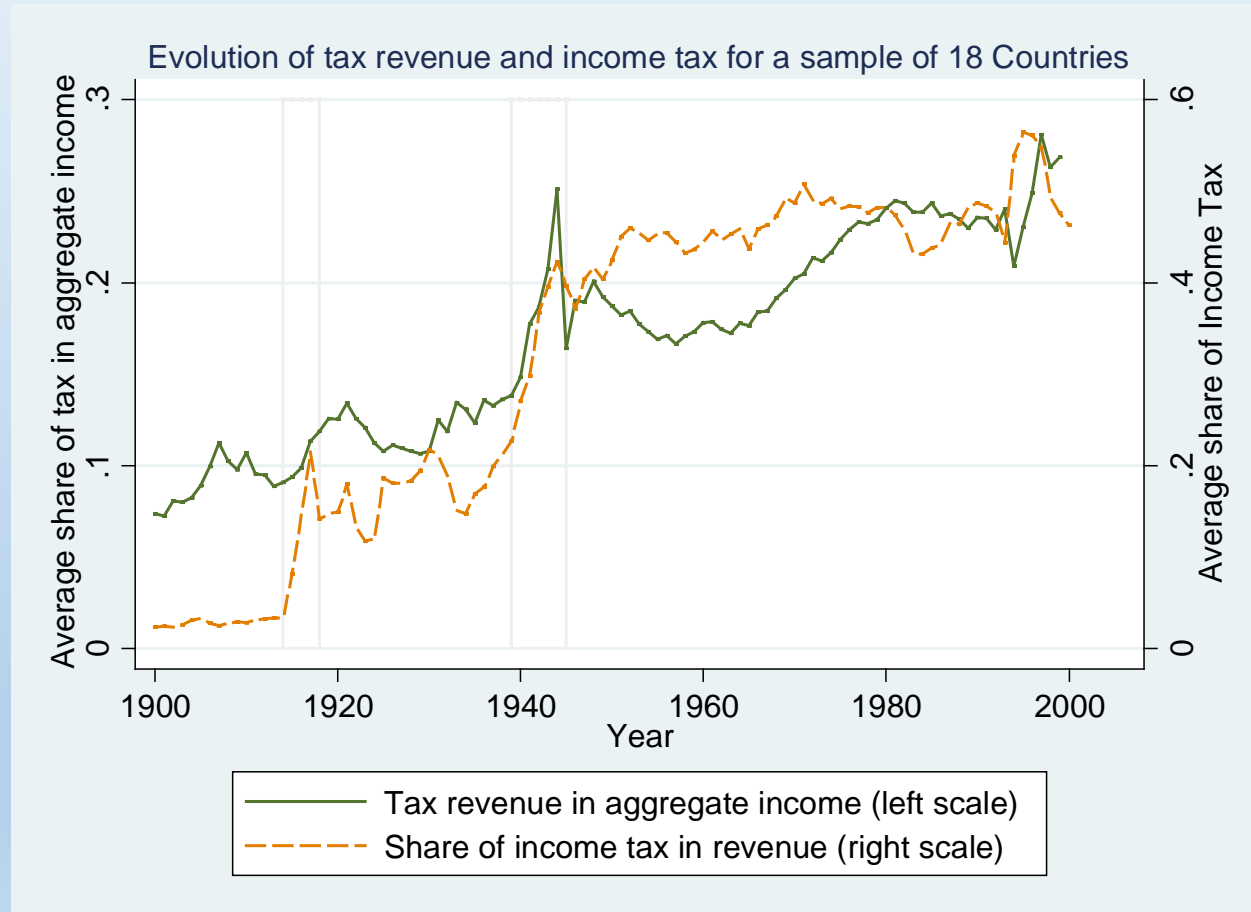
Political and Economic Change in the US South



Investments: The Role of State Capacities

- State functioning is dependent on a range on investments in effectiveness
 - Fiscal systems
 - Legal systems
 - Collective provision
- This changes incentives and can have a feedback effect onto institutional development

The Case of Fiscal Capacity



The State Capacity Agenda

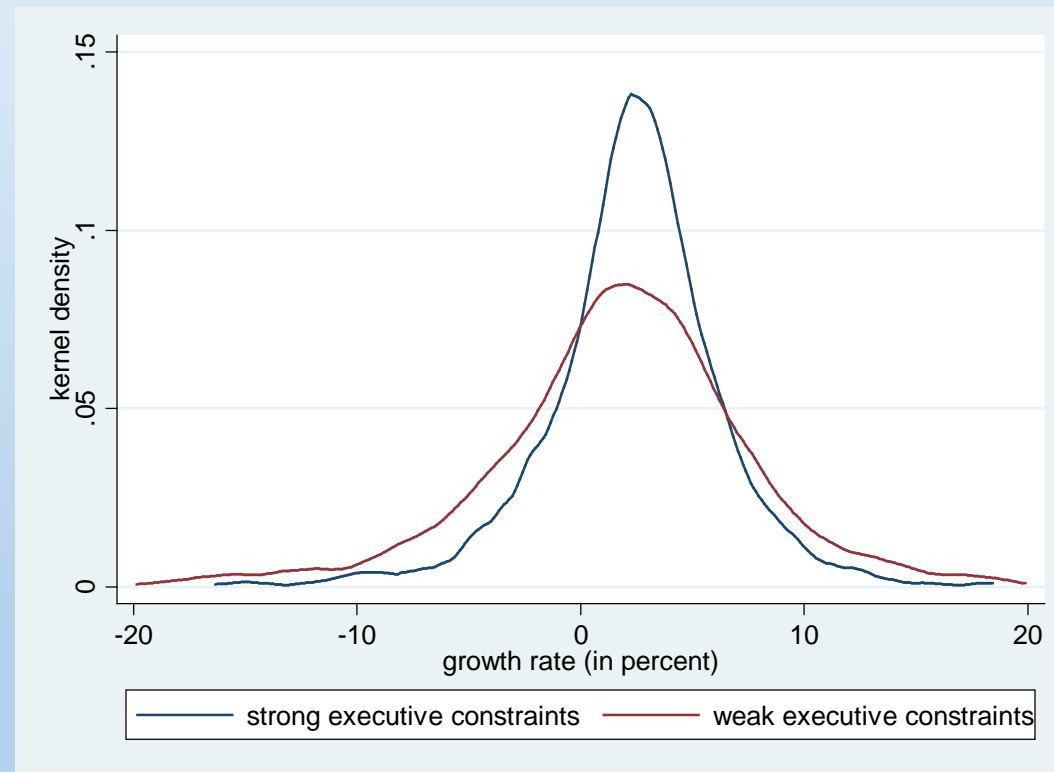
- State capacity investments persistence in institutions
 - Effective legal institutions allow executive constraints to be embedded
 - Creating broad-based taxation increases demands for transparency and accountability
 - Collective programs reinforce need for broad-based political coalitions
- Also creates demand for complementary specialized forms of human capital (skills)

Cultural Inertia

- Most mainstream economists are reluctant to invoke cultural explanations of economic phenomena
- What does culture mean?
 - Indirect evolutionary models of preference formation
 - Norms “learned” from repeated social interaction
- Economists are now beginning to discuss how these can explain:
 - Differences in how institutions work in different contexts
 - Patterns of institutional change

Case Study 3

Political Institutions and Robust Control



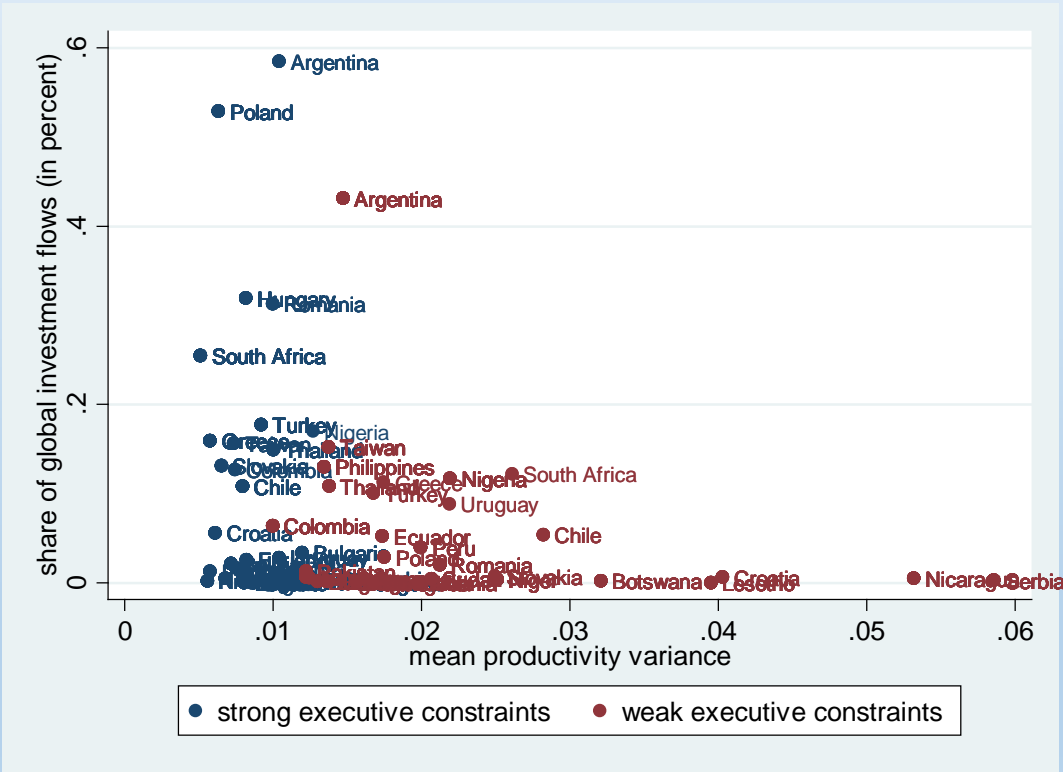
Political Institutions and Robust Control

- "Robust control methods seek to bound the uncertainty rather than express it in the form of a distribution. Given a bound on the uncertainty, the control can deliver results that meet the control system requirements in all cases. Therefore robust control theory might be stated as a worst-case analysis method rather than a typical case method. It must be recognized that some performance may be sacrificed in order to guarantee that the system meets certain requirements. However, this seems to be a common theme when dealing with safety critical embedded systems." Leo Rollins, Robust Control Theory,
http://www.ece.cmu.edu/~koopman/des_s99/control_theory/

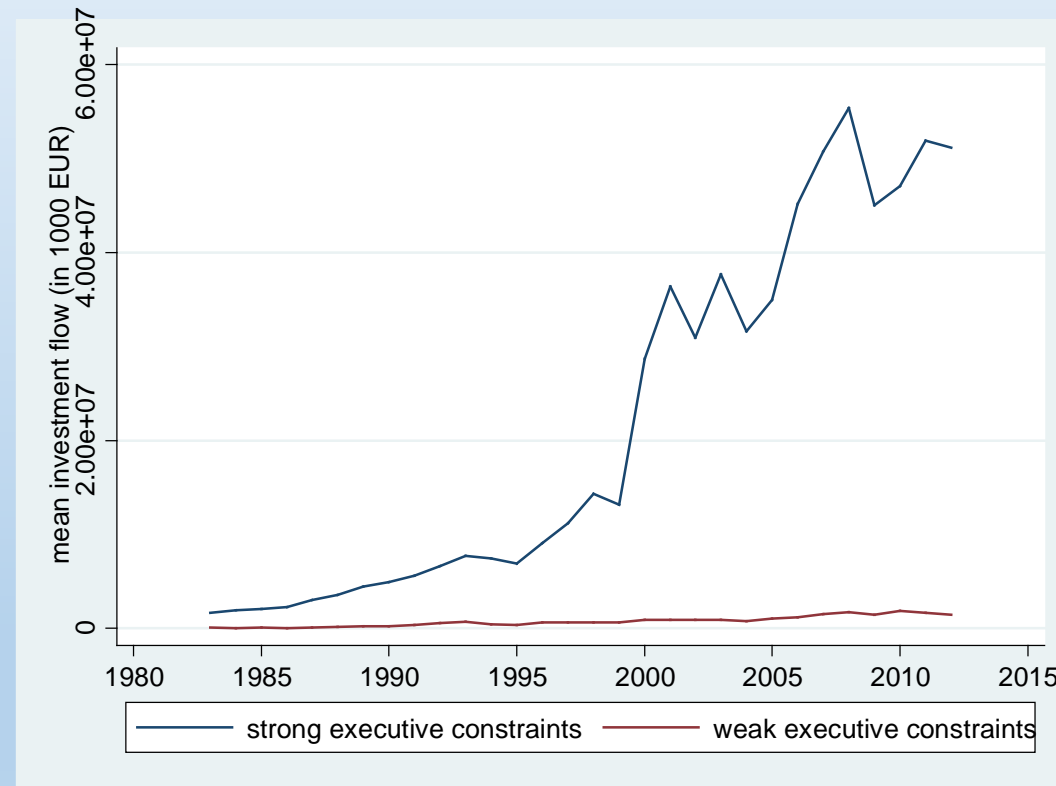
Political Institutions and Robust Control

- Constraints reduce discretion of policy-makers
 - Legislative constraints
 - Legal constraints
- This has costs and benefits
 - But can in particular limit the downside
 - And can create a more stable/predictable policy environment

Institutions and Reductions in Variance

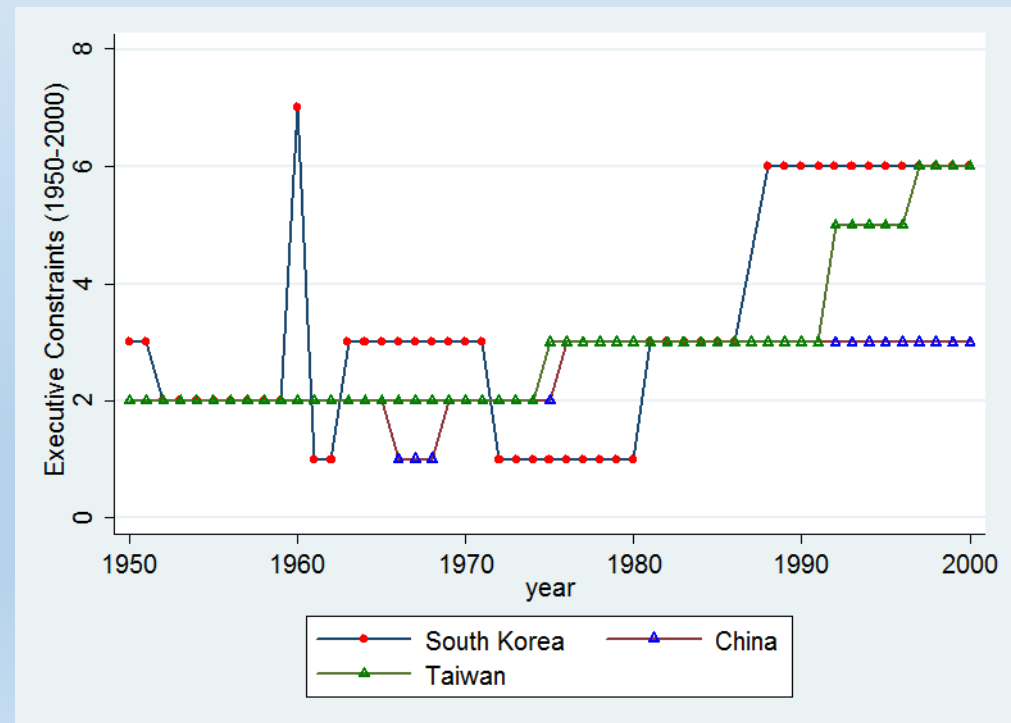


Does Risk Mitigation Matter?



Implications

- Does weak executive constraints compromise the ability of countries to respond effectively to shocks?
 - Recent volatility in China should be seen in this context
 - Which path will China follow?



Practical Engagement

- Two sources of change in political structures
 - “Autonomous” internal reform
 - External interventions
- Colonialism and war have been the main two forces of external intervention
 - The world has struggled for a coherent alternative
- Efforts via aid and IFIs
 - But they have struggled when it comes to political economy considerations

Status of Politics

- Politics creates complications which go beyond what economics alone can say
 - But politics is not a *constraint* which needs to be navigated around
- Need to engage with core questions about institutional reform
 - What changes can be advised on which make policy reform more sustainable.
- Field of political economy should be helpful in pointing out ways of achieving sustainable and effective policy change

Examples of Piecemeal Institutional Reform

- Political Reservation
- Effective forms of regulation – e.g. competition policy with specialized courts
- Independent central banks
- Watchdogs to oversee public finances/reduce corruption
 - Fiscal councils
 - EITI
- The institutional architecture for infrastructure investment

Bottom Line

- Political Economy has widened the tool kit which economists have available to study policy success and failure
- It enables economists to engage in constructive ways about policy change/reform
- And this has enriched debates about development patterns and the policies that support inclusive and sustainable development
- My hope would be that W. Arthur Lewis would have seen this as a source of progress in our discipline

Thank You



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