Policy Reforms, Growth and Governance: The Political Economy of Bangladesh’s Development Surprise

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I. Introduction

Bangladesh emerged from its war of independence desperately poor and over-populated and reeling from overwhelming war damage to its institutional and physical capital. It was not until 1978/79 that per capita income had recovered to its pre-independence level. The economy was ravaged by acute food shortages and famines during the early years. According to some authors, Bangladesh was designated as a “test case” for development while Henry Kissinger called it “an international basket case”.

Thirty some years later, doubts and doubters have been proven wrong. With sustained growth in food production and a good record of disaster management, famines have become a phenomenon of the past. Bangladesh’s per capita GDP has more than doubled since 1975. Life expectancy has risen from 50 to 63 years; population growth rates of 3 percent a year have been halved, child mortality rates of 240 per 1,000 births have been cut by 70 percent, literacy has more than doubled, and the country has achieved gender parity in primary and secondary schools.

Most of these gains have taken place since the early 1990s, when the introduction of wide-ranging economic reforms coincided with transition to democracy. The growth of per capita GDP had been slow in the 1980s, at an annual average of 1.6 percent a year, but it accelerated to 3 percent in the 1990s, and to about 4 percent in the more recent period. The acceleration resulted partly from a slowdown in population growth but also from a sustained increase in GDP growth, which averaged 3.7 percent annually during the 1980s, 4.8 percent during the 1990s and 5.6 percent since then. Progress in the human development indicators was even more impressive, and Bangladesh ranked among the top performing countries in the 1990s in the extent of improvement in the UNDP Human Development Index.¹

Bangladesh’s above achievements may appear as a “development surprise”, given the country’s desperate initial conditions and allegedly poor record in governance adversely affecting the investment climate and the quality of public service delivery.

¹The absolute increase in the value of Human Development Index for Bangladesh between 1990 and 2001 is surpassed only by that for China and Cape Verde among all the countries for which such estimates are available; UNDP (2003), pp. 241-244.
(Ahluwalia and Mahmud 2004, Devarajan 2005, Ahmed 2005). The following questions have been raised: how could the progress achieved thus far have been possible without concomitant institutional development?; can further progress be sustained without strengthening the country’s institutions of political and economic governance?; how was the policy–making process, including the design and implementation of policies and their outcomes, shaped by the prevailing political economy environment and the governance challenges? This paper attempts to answer these questions.

II. Development Strategy, Policy Shifts, Macroeconomic Trends and Growth Performance

The development strategy in Bangladesh since the early 1970s has undergone successive shifts and refinements along with associated changes in the policy environment, often linked with the change in the ruling political regime.

In the early years following the War of Liberation in 1971, Bangladesh adopted a socialistic development strategy. Economic management was primarily aimed at reviving a war-ravaged economy in an overall framework of extensive state control and with an avowed ideology of socialism (Ahmed 2000). The state became the de facto owner of a large number of enterprises that had been abandoned by their Pakistani owners. After the killing of Sheikh Mujib and the change of government and with General Ziaur Rahman emerging as the military ruler, there was a policy shift towards privatisation and the promotion of the private sector. The denationalisation of abandoned enterprises continued in varying speed into the 1980s when a second wave of divestment was initiated under the military government of General Ershad.

From the late 1970s to the beginning of the 1980s, there was a short-lived episode of investment boom, with investment in both public and private sectors growing at nearly 15 percent annually in real terms (Mahmud 1995). This was made possible by relying on an increasing flow of foreign aid and adopting a privatisation strategy based on lavish dispensation of cheap credit and provision of other incentives such as highly protected markets for domestic industries. To a large extent, the latter-day problems regarding the so-called 'sick' industries and the large-scale default of bank loans originated from this experiment with aid-dependent state-sponsored private capitalism. There was no mobilisation of domestic savings, so that the investment boom ended abruptly when the external aid climate severely deteriorated in the early 1980s.

A major change of direction occurred in the early 1980s with the adoption of a market-oriented development strategy supported by a number of liberalising policy

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2 General Zia later formed the Bangladesh Nationalist Party (BNP), which emerged as one of the two major political parties in Bangladesh, the other being Sheikh Mujib’s Awami League.

3 Like General Zia, General Ershad also later gave a civilian face to his regime by forming a political party.

4 The subsequent decline of the development financing institutions (DFIs) was also closely linked to the shortcomings of that round of privatisation in Bangladesh.
reforms undertaken in partnership with the World Bank and the IMF and implemented under fairly rigid aid conditionality. These reforms were initiated against the backdrop of serious macroeconomic imbalances, which had been caused in part by a decline in foreign aid and in part by a preceding episode of severe deterioration in the country's terms of trade. The policy reforms in the 1980s included mainly the withdrawal of food and agricultural subsidies, privatisation of selected state-owned enterprises, partial financial liberalisation, and withdrawal of quantitative import restrictions. Nevertheless, many state controls remained along with heavy trade protection (Ahmed 2002).

The beginning of the 1990s saw a major refinement of the market-oriented development strategy with greater focus on openness to trade competition and integration with the global economy. This was supported by the launching of a more comprehensive programme of macroeconomic and structural reforms, which coincided with a transition to parliamentary democracy from a semi-autocratic rule. These later reforms were particularly aimed at moving towards an open economy – such as making the currency convertible on the current account (leading to a floating exchange rate in 2003), reducing import duties generally to much lower levels, and removing virtually all controls on the movements of foreign private capital. Besides, the reforms also included financial liberalisation with deregulation of interest rates and fiscal reforms including the introduction of the value-added tax (Ahmed 2005).

**Trends in Macroeconomic Indicators**

The reforms initiated in the 1980s were aimed at reducing the fiscal and external deficits to a sustainable level, consistent with the reduced level of aid availability. The trends in various macroeconomic indicators over the last two decades are shown in Table 1. During the 1980s, the fiscal deficit came down from 6.6 per cent of GDP in the first half of the decade to 5.4 per cent in the second half, while the external current account deficit was reduced from 6.7 per cent to 4.7. But this success was achieved at some cost. The macroeconomic balances were improved not so much by raising revenue or exports, but by squeezing expenditure on the fiscal front and imports on the external front. Thus, between the two halves of the decade, the tax-GDP ratio barely increased, while development expenditure as a percentage of GDP declined from 6.6 per cent to 5.4 per cent. Similarly, export revenue as a percentage of GDP barely increased, while the import-GDP ratio declined from 14.3 per cent to 12.8 per cent. Thus, as in the case of most other early experiments in structural adjustment, the attempt to achieve macroeconomic stabilisation in Bangladesh in the 1980s was made along the contractionary route. The main reason why macroeconomic adjustment did not provide

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5 For a discussion on these reforms and the macroeconomic developments in the 1980s, see Task Forces (1991)

6 One redeeming feature of the macroeconomic developments in the 1980s as shown in Table 1 is the increase in public investment. This increase, however, barely compensated for the decline in private investment, resulting in a slight decline in the overall investment rate. However, the actual investment scenario of the decade was probably much worse. The figures in Table 1 are based on the revised national income series, which was initially estimated from 1990-91 onward, but was subsequently extended backward to cover the period of the 1980s. In spite of the improved estimation methodology used in the
the required impetus to growth and resource mobilization was that the sectoral reforms needed to boost the supply response from the private sector were very limited. Numerous investment controls and trade protection prevented competition while banking sector reforms did not happen\(^7\). Indeed, the lack of saving response and weak private investment is to a significant extent a reflection of the inefficient banking sector. The Bangladesh experience of this period illustrates the well accepted conclusion that macroeconomic stability is a necessary but not a sufficient condition for accelerating growth (Ahmed 2006).

The launching of the wide-ranging policy reforms since the beginning of the 1990s was followed by some very positive developments in the economic performance. There was a marked improvement in the government’s budgetary position, particularly in terms of increased revenue mobilisation in the early 1990s. While the net inflow of foreign capital further declined to around 2 per cent of GDP, both investment and saving rates steadily improved, thus paving the way for superior growth performance. The ratio of investment to GDP, which had stagnated at less than 17 percent in the 1980s, increased to about 23 percent towards the end of the 1990s. This increase was almost entirely due to the dynamism in private investment, which has risen from less than 10 percent of GDP to about 16 percent since the late 1980s, with the investment rate in the public sector remaining almost unchanged at around 6 to 7 percent of GDP (Mahmud 2004).

The growth of GDP, which averaged 3.7 percent annually during the 1980s, increased to 4.4 percent in the first half of the 1990s, and further to 5.2 percent in the second half. Meanwhile, due to robust and sustained growth in export earnings, the export-GDP ratio increased from less than 6 percent in the later half of the 1980s to the current level of above 15 percent. With the accompanying increase in imports, the trade openness of the economy (that is, the combined ratio of imports and exports to GDP) nearly doubled during the same period.

All this was achieved along with remarkable success in keeping inflation under control. In the first half of the 1980s, the average annual rate of inflation as measured by the consumer price index was relatively high at 13 per cent. It is only the contractionary effect of macroeconomic adjustment of that period that brought inflation down – to around 8 per cent in the second half of the decade. During the 1990s, there was further decline in the inflation rate – down to 5.6 per cent in the first half of the decade and 5.8 per cent in the second, and this time the reduction was achieved despite relative buoyancy of the economy compared to the preceding decade. The 1990s thus saw positive developments on several fronts: transition to parliamentary democracy, strengthening of economic growth performance, and consolidation of economic stabilisation in the face of

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\(^7\) Banking reforms in Bangladesh started only after 2000. For a review of banking sector reforms and performance see Ahmed 2005.
Table 1. Macroeconomic Balances, 1980/81 – 2000/05; 5-Year Averages
(figures are in percentages of GDP at current market prices unless otherwise noted)

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<tbody>
<tr>
<td><strong>External sector</strong></td>
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</tr>
<tr>
<td>Exports of goods and services</td>
<td>5.4</td>
<td>5.6</td>
<td>8.6</td>
<td>12.7</td>
<td>15.2</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>14.3</td>
<td>12.8</td>
<td>12.6</td>
<td>17.3</td>
<td>20.9</td>
</tr>
<tr>
<td>Trade deficit</td>
<td>8.9</td>
<td>7.2</td>
<td>5.4</td>
<td>6.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Workers’ remittances(^1)</td>
<td>2.7</td>
<td>2.9</td>
<td>2.9</td>
<td>3.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Current accounts deficit(^2)</td>
<td>6.7</td>
<td>4.7</td>
<td>2.1</td>
<td>1.9</td>
<td>-0.6</td>
</tr>
<tr>
<td><strong>Investment and Savings</strong></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Gross Investment</td>
<td>16.9</td>
<td>16.6</td>
<td>17.9</td>
<td>21.5</td>
<td>23.6</td>
</tr>
<tr>
<td>Public</td>
<td>4.8</td>
<td>6.1</td>
<td>6.7</td>
<td>6.8</td>
<td>6.4</td>
</tr>
<tr>
<td>Private</td>
<td>12.1</td>
<td>10.4</td>
<td>11.3</td>
<td>14.7</td>
<td>17.2</td>
</tr>
<tr>
<td>Gross domestic savings(^3)</td>
<td>8.00</td>
<td>9.4</td>
<td>12.5</td>
<td>15.3</td>
<td>16.9</td>
</tr>
<tr>
<td>Gross national savings(^4)</td>
<td>10.7</td>
<td>12.3</td>
<td>15.5</td>
<td>18.9</td>
<td>23.0</td>
</tr>
<tr>
<td><strong>Government Budget</strong></td>
<td></td>
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<tr>
<td>Total revenue</td>
<td>6.3</td>
<td>6.7</td>
<td>8.6</td>
<td>9.0</td>
<td>10.0</td>
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<tr>
<td>Tax revenue</td>
<td>5.2</td>
<td>5.4</td>
<td>6.9</td>
<td>7.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>4.6</td>
<td>6.0</td>
<td>6.5</td>
<td>7.2</td>
<td>8.2</td>
</tr>
<tr>
<td>Development expenditure(^5)</td>
<td>6.6</td>
<td>5.4</td>
<td>5.6</td>
<td>5.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Total expenditure(^6)</td>
<td>12.9</td>
<td>12.2</td>
<td>13.4</td>
<td>13.4</td>
<td>14.0</td>
</tr>
<tr>
<td>Budget deficit</td>
<td>6.6</td>
<td>5.6</td>
<td>4.8</td>
<td>4.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Domestic borrowing(^7)</td>
<td>1.0</td>
<td>0.5</td>
<td>0.8</td>
<td>1.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Foreign financing(^8)</td>
<td>5.6</td>
<td>5.0</td>
<td>4.0</td>
<td>2.5</td>
<td>1.8</td>
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<tr>
<td><strong>Monetary Policy</strong></td>
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<tr>
<td>Growth rate of M1 (% pa)</td>
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<tr>
<td>Growth rate of M2 (% pa)</td>
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<tr>
<td>Inflation rate (CPI) (% pa)</td>
<td></td>
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</tbody>
</table>

**Notes:**
\(^1\) Remittances from Bangladeshi workers abroad.
\(^2\) Equals trade deficit minus net factor income from abroad; the latter includes private transfers (mainly remittances), interest payments on external public debt and other investment incomes; differs from the official estimates because of not including official transfers (foreign aid as grants); a negative value implies surplus.
\(^3\) Equals gross investment minus trade deficit; also equals gross national savings minus net factor income from abroad.
\(^4\) Equals gross investment minus current account deficit.
\(^5\) Expenditure under Annual Development Plan (ADP).
\(^6\) Includes food account balance and certain capital expenditures and net lending not included in the development budget.
\(^7\) Includes net borrowing from the banking system and net sale proceeds of savings certificates.
\(^8\) Includes grants and concessional loans net of amortization.
declining foreign capital inflow. Clearly, the combination of macroeconomic adjustment to stabilize the economy along with a range of structural reforms in trade, finance and domestic deregulation spurred private investment and generated a strong supply response. This said, there were some periodic lapses in the macroeconomic discipline - particularly related to the timing of approaching national elections - thus producing the symptoms of the so-called "political business cycle".  

Sources of Growth Stimulus

All broad sectors of the economy - agriculture, industry, and services - have contributed to the growth acceleration since the early 1990s. The average annual growth of agricultural GDP accelerated from 2.5 percent in the 1980s to 3.2 percent in the 1990s, industrial GDP from 5.8 to 7.0 percent and the service sector GDP from 3.7 to 4.5 percent. In spite of some fluctuations in crop production, the volatility in long-term GDP growth in Bangladesh is found to be remarkably low among developing countries.

Within manufacturing, the growth has come largely from the ready-made garment industry; during the 1990s, medium- and large-scale manufacturing as a whole grew at about 7 percent annually, but at only about 4 percent excluding the garment industry. This implies that growth in the organized manufacturing sector has been mainly export-led. But it also means that the manufacturing and export base of the economy has become more concentrated rather than more diverse. Fisheries have been another high performing activity, with an annual growth rate rising from about 2.5 percent in the 1980s to more than 8 percent in the 1990s. It is noteworthy that, aside from garments, frozen shrimp was the only fast-growing major export item in the 1990s (Table 2). The growth of export items lumped under “other exports” is an encouraging sign that continued improvement in export incentives might foster the needed export diversification. Yet, the values of these exports are still too low to allow a definite conclusion about whether diversification is already underway.

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8 In 1995-96 and 2000-01, both pre-election years, the government's domestic borrowing and the rate of credit expansion in the private sector were unusually high, while trade deficits increased substantially and foreign exchange reserves fell; see Mahmud (2002), Chapter 19 and Bangladesh Economic Survey, Ministry of Finance (various issues).
9 The estimates are derived from the official national income statistics. The industrial sector includes construction, mining, and utilities, besides manufacturing.
11 These are estimated annual compound growth rates between the years 1991/92 and 1999/2000 and are based on the official national income statistics as reported in the annual Statistical Yearbook of Bangladesh of the Bangladesh Bureau of Statistics.
12 For a recent review of export performance and policies see Ahmed and Sattar (2004).
Table 2: Bangladesh: Growth of Exports since 1990

(Annual export earnings in million US dollars)

<table>
<thead>
<tr>
<th>Export item</th>
<th>1990/91</th>
<th>2004/05</th>
</tr>
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<tbody>
<tr>
<td>Textiles (mainly readymade garments and knitwear)</td>
<td>890</td>
<td>6,418</td>
</tr>
<tr>
<td>Frozen foods (mainly frozen shrimp)</td>
<td>142</td>
<td>421</td>
</tr>
<tr>
<td>Raw jute and jute goods</td>
<td>395</td>
<td>404</td>
</tr>
<tr>
<td>Leather and leather goods</td>
<td>137</td>
<td>221</td>
</tr>
<tr>
<td>All other exports</td>
<td>510</td>
<td>1,190</td>
</tr>
<tr>
<td>Total exports</td>
<td>1,718</td>
<td>8,654</td>
</tr>
<tr>
<td>Of which, manufactured exports</td>
<td>1,411</td>
<td>8,006</td>
</tr>
</tbody>
</table>

Sources: Official export data of the Export Promotion Bureau as reported in Bangladesh Bank’s Annual Report (various years) and World Bank (2005).

Until hit by the global recession in 2001, Bangladesh had achieved robust and sustained growth of export earnings, averaging about 15 percent a year in nominal US dollar terms in the 1990s. In 2001-02, export earnings declined in dollar terms for the first time since 1985-86, but there was a recovery in the following year and export growth has remained strong since then. In fact, Bangladesh seems to have successfully withstood the initial impact of the post-MFA competition in the global markets for garment export the real test may yet to come. Another positive factor has been the continued growth in the inflow of migrant workers’ remittances—from about 2.5 percent of GDP in the beginning of the 1990s to more than 6 percent in 2004-05, amounting to about US$ 3.8 billion annually.

Exports are, however, only a part of the growth dynamics in Bangladesh. Though the structure of the economy is changing, the organized sectors of the economy still remain relatively small with no more than 12 percent of GDP currently originating from large- and medium-scale manufacturing. Agriculture still contributes about 20 percent of GDP, and a much larger share of GDP originates from the so-called informal sectors outside agriculture: small-scale processing and manufacturing and various informal services. The growth rates of these informal activities accelerated in the 1990s, contributing substantially to the acceleration of overall GDP growth (Osmani et al. 2003). Many of these activities—being extremely labour-intensive and requiring very little capital investment—are largely demand-driven, responding to at least three major sources of increased income: crop production, readymade garment exports, and workers’ remittances, in that order of importance.  

13 According to the official 1999/00 Labor Force Survey, these informal activities employ about three-fourths of the country’s non-agricultural labor force.

14 For an estimation of the relative importance of these growth stimuli, see Osmani et al. (2003).
Though these informal activities have expanded largely as the result of demand linkages with the leading productive sectors of the economy, they have had their internal growth dynamics as well. There is evidence that their growth acceleration in the 1990s was accompanied by a tilt towards relatively scaled-up activities that use labour more productively and can cater to more income-elastic demand (Mahmud 2003). Import liberalization is likely to have played a role here, by allowing better access to imported inputs and technology. For example, in the post-liberalization period, small-scale manufacturing activities (excluding handlooms and cottage industries) fared better than large-scale manufacturing, growing at an average rate of more than 9 percent annually in the 1990s. Small industries seem to have benefited from the liberalization of imports of capital machinery and raw materials, while their products—being mostly remote substitutes for imported items—had an advantage over those of their large-scale counterparts, which faced stiffer competition from imports.

III. Policy-making Process: Economic Rationale and Political Incentives

It was out of pragmatism that the shift in policy away from socialism to private sector development was initiated within a few years after independence. The state policy of socialism, which was included in the declaration of independence, was hardly taken seriously and was formally deleted from the country’s constitution during the Ershad regime. The operation of the nationalised industries, previously abandoned by their Pakistani owners, was driven by the objective of enriching a few politically favoured private individuals. But, as mentioned earlier, the initial process of private sector development as pursued during the regime of general Zia turned out to be an early version of what is now called ‘crony capitalism’. The market-oriented liberalising policy reforms were initiated around the mid-1980s with the support of the IMF and the World Bank, and have been followed through since then in various phases. The reforms have been implemented under fairly rigid aid conditionality (Task Forces 1991). Yet, in spite of the leveraging role of such aid conditionality, the sequencing, design and implementation of policies had much to do with the political incentives vis-à-vis the economic rationale of such policies.

Reducing Agricultural and Food Subsidies

As part of the above reforms, the early emphasis on privatisation of marketing of agricultural inputs and withdrawal of agricultural subsidies made sense on grounds of pragmatism. By the late 1970s, about one-third of the entire development budget used to have been eaten up by agricultural input subsidies. To promote modern rice technology, government policies had emphasised the public distribution of fertilisers and renting of publicly owned irrigation equipment at a heavy subsidy. These policies did have a major role in the initial adoption of the modern HYV rice technology; but the budgetary costs

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16 Small industries are likely to have grown also at the cost of cottage industries, whose value added grew at only 2.8 percent annually during the same period.
became unsustainable. The rationale of providing input subsidy was also weakened once farmers became familiar with the use of modern inputs.

Debates on agricultural subsidies still reappear from time to time. The case for agricultural subsidies is made partly from a general populist stance, but partly also on grounds of helping the poor farmers (who may lack access to credit to use inputs at optimal levels) and facilitating agricultural rehabilitation after natural disasters like floods. It is true that the withdrawal of high input subsidies made rice production less profitable, since the subsidy withdrawal was not compensated by the avowed policy of supporting rice harvest prices through public procurement of rice – a policy which was hardly effective. Nevertheless, the promise of price support, along with the absence of strong agricultural lobbies, helped the implementation of the policy of subsidy withdrawal. According to the findings of a “participatory” research conducted later to assess the impact of structural adjustment reforms, the farmers did not think the reintroduction of large subsidies on agricultural inputs to be a realistic proposition, but they did expect the government to have a role in supporting agricultural growth.17 The same study also found that the farmers did not also expect their agricultural loans to be written off, although successive governments did include it in their election manifestoes. It is thus the electoral competition rather that genuine popular expectations that seem to give rise to economic populism.18

The government control on tube-well irrigation was abolished through the sale of government-owned irrigation equipment and allowing free import of such equipment. The policy was criticised by some on the ground that it favoured the big farmers who emerged as the major suppliers of water to smaller farmers at a high price, particularly since such irrigation is like a natural monopoly in the so-called “command area” of a tube-well.19 This argument, however, did not gain much ground as subsequent evidence showed that the policy led to a spurt in private investment in tube-well irrigation contributing to growth in food grain production 20

At about the same time as agricultural subsidies were being reduced, public food distribution in the form of food rations in urban and rural areas was also gradually phased out. The budgetary burden was again a consideration, but there was also a widely held view, supported by study findings, that the poorest families did not have access to the food rations. Even then, the abolition of the food rationing system was not an easy decision, given that the politically vocal urban middle class was its main beneficiary. In many other countries, attempts to abolish such food rations met with violent political protests. The success of the reform programme regarding the public food distribution system in Bangladesh is partly explained by its gradualism and its clever design. In the

17 This so-called Structural Adjustment Participatory Research (SAPRI) was sponsored by the World Bank in collaboration with a coalition of international NGOs and national governments; see Mahmud (2002a), Chap. 1.
18 Populist policies should be, however, distinguished from the genuine need to incorporate the ‘voice’ and participation of the people in economic decision-making process; see Mahmud (2000a), Chapter 1.
20 Ahmed (2001), Chap. 5.
years of high food grain prices, the ration prices were raised without creating much resentment (because of still higher market prices), but the ration prices were not reduced in years of low market prices (which again was acceptable, since only an increase in ration prices was a sensitive issue). The gap between the market and ration prices was thus gradually reduced, so that ultimately there was little incentive for the beneficiaries to access such rations (Rahman and Mahmud 1988). On the other hand, there was a strong case on equity grounds in support of the policy to continue with, and even strengthen, the food distribution programmes targeted to the poor, such as those relating to food-for-work and feeding vulnerable women and children.

*External Sector Reforms*

The reforms towards trade liberalisation in Bangladesh followed a logical sequence: the relaxation and withdrawal of import quota restrictions along with the unification of the exchange rate and devaluation of the domestic currency during the late 1980s, followed by large reductions in import tariffs in the first half of the 1990s. But since then further import liberalisation has been rather slow. Taking into account all import duties having a protective effect, the un-weighted average import duty rate declined from 74 percent in 1991-92 to 32 percent in 1996-97 and 29 percent in 2003-04. The slower decline since the mid-1990s is partly because cuts in customs duties were offset by other protective duties and para-tariffs (World Bank 2004, Mahmud 2004). As a result of these reforms, Bangladesh still has a relatively closed economy.

**Table 3. Average Rates of Customs Duties and All Protective Import Duties**

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<tr>
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<tbody>
<tr>
<td>Average customs duty, unweighted (%)</td>
<td>70.6</td>
<td>28.7</td>
<td>18.8</td>
<td>16.3</td>
</tr>
<tr>
<td>Total protection rate, unweighted (%)³</td>
<td>73.6</td>
<td>32.0</td>
<td>29.1</td>
<td>26.5</td>
</tr>
<tr>
<td>Average collection rate (%)⁴</td>
<td>28.7</td>
<td>23.7</td>
<td>18.0</td>
<td>n.a</td>
</tr>
<tr>
<td></td>
<td>(37.4)</td>
<td>(31.8)</td>
<td>(25.5)</td>
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*Notes:*

¹The average rates reported here are based on 8-digit 6877 tariff lines; they do not include tariff exemptions or concessions, nor do they reflect 'preferential' tariffs.

²According to the budget for the financial year 2004/05.

³Total protection' incorporates, in addition to customs duty, protection provided by the Infrastructure Development Surcharge, License Fee (LF), Regulatory Duty (RD), as well as protection resulting from asymmetric implementation of the Supplementary Duty and VAT. Asymmetric implementation results when the so-called protection-neutral taxes are levied on only imports but not on domestic production and/or when higher rates are applied on imports than on domestically produced substitutes.

⁴The collection rate reflects tax exemptions as well as tax evasion; includes duties on all lines of import items, but not the advance income tax on imports. Figures within brackets relate to imports excluding duty-free export-related ones.

*Source: Estimated from World Bank (2005), Table 3.1, p. 16.*
The devaluations of the exchange rate of Taka – both in nominal and real terms – during the late 1980s, along with relatively sluggish growth in import demand of that time, resulted in the gradual erosion of premium on import licences. There were thus no strong lobbies of import-license-holders opposing the reforms. The removal of import restrictions and a flexible management of the exchange rate eventually led to making the taka convertible on the current account and more recently, in a system of managed free float. This helped to provide incentives for export as well as for attracting migrant workers’ remittances from abroad.

An important concern regarding trade liberalization is the possible adverse effect of tariff reductions on government revenue. Thus far, the revenue effects of reductions in the rates of customs duties have been more than offset by the growth of imports (Mahmud 2004). More than half of total tax revenue still comes from import duties, even though the introduction of the value-added tax has reduced the dependence on such duties. In fact, revenue concerns rather than protectionist appeals seem to have a stronger deterrent to faster import liberalisation. This is evident from the pattern of reductions in import duties: the government sought to protect revenue by reducing tariff on minor items rather than those with a large recorded import value.21

One reason why tariff reforms have not been strongly resisted by domestic industrial lobbies is the end-use based discrimination in protective duty rates. Capital goods and primary commodities are subject to much lower rates of tariffs compared to intermediate goods, while the highest rates apply to finished consumer goods. This has helped to retain relatively high rates of protection for the later goods even within the much lower average import tariffs; at the same time, the anti-export bias of the tax system has been reduced to some extent because of lower taxes on imported inputs. Such a system of tariff escalation has suited the interest of the protectionist lobbies, since the domestic import-substituting industries mainly produce finished consumer goods.22 But even within such a policy of tariff escalation, revenue concerns dominated over protectionist ones, so that duties on major imported intermediated goods remained higher than those on relatively minor ones (as reflected in the higher estimated import-value-weighted average duty rate compared to the un-weighted rate in respect of this category of imports).

The prospect for export growth and diversification may provide further leverage for import liberalisation. Most industrialists in Bangladesh now have a stake in the export-oriented garment industry. The other fast-growing industries like pharmaceuticals and ceramics have gone into the export market after graduating from being entirely

21 As a result, for the period of rapid tariff reductions in the early 1990s, the import-weighted estimates of average import duty rates (both in respect of total import duties and protective duties) showed a much smaller decline than the unweighted estimates; see Mahmud 2001, Chapter 3, p. 55.
22 The system of incentives thus created has worked against a “deepening” of the domestic manufacturing structure, making it even more import dependent. In particular, there is evidence that the reforms of the duty structure have thwarted the growth of a nascent domestic engineering and capital goods industry; Mahmud (2004).
import-substituting industries. This may weaken the resistance to further reducing the anti-export bias in the duty structure that now exists.

The extent and speed of further import liberalization remain a contentious issue in the country's economic reform agenda. In the absence of any pre-announced target and timetable, tariff reform in Bangladesh would seem to be a 'learning-by-doing' process (even if not consciously recognised to be so). The credibility of such an approach depends on the government's willingness and capability to conduct trade policy reforms in an analytical way. The impact of protection afforded through tariff escalation and the selective interventions for export promotion is bound to be somewhat discriminatory in nature, although the room for such discrimination may be gradually reduced with further liberalisation. The government conducts its trade and tax policies in close consultation with the business communities and is sensitive to their demands. But, in the absence of enough in-house analytical capability of its own, the removal of some ‘anomalies’ in the tax structure in response to the businessmen’s demands often lead to other anomalies.

**Fiscal Policy and Public Expenditure**

As noted earlier, the transition to democracy resulted in improved fiscal management and macroeconomic discipline. There was more revenue mobilisation and a greater restraint on the growth of current expenditures. Budgetary deficits were prudently managed in the face of declining foreign aid so as not to crowd out private sector’s borrowing. Overall monetary policy was conducted in a way to keep inflation low – and this was not just because of the IMF’s stipulations, but perhaps more due to the government’s political sensitivity to inflation.

The increase in the tax-GDP ratio in the early 1990s was largely due to the introduction of the value-added tax and turned out to be of a once-and-for-all nature. The revenue-GDP ratio is very low in Bangladesh even by the standards of developing countries and the reason lies mostly in large-scale tax evasion. Enforcing better tax compliance has a political cost for the government in terms of alienating the better-off people and the business community, while the revenue foregone due to tax evasion curtails government’s ability for development spending, which is the flexible part of budgetary expenditures. In this trade-off, the government seems to have chosen the option of a relatively low tax effort.

The patterns of public development spending have undergone significant changes reflecting the changing developmental role of the government under the economic reforms (Mahmud 2002, Ahmed 2005). The government has gradually withdrawn from the directly productive sectors, while concentrating more on providing public goods in the form of education and health, physical infrastructure, and rural development. As can be seen from Table 4, the proportional budgetary allocations to education and health have continuously increased all throughout the reform period beginning from the early 1980s.
Table 4: Government Expenditure on Health and Education (as Shares of the Budget and as Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>80/81-84/85</th>
<th>85/86-89/90</th>
<th>90/91-94/95</th>
<th>95/96-99/00</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percent of Total Budget</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>8.16</td>
<td>11.24</td>
<td>13.62</td>
<td>15.51</td>
</tr>
<tr>
<td>Health &amp; Population Planning</td>
<td>5.40</td>
<td>5.88</td>
<td>6.77</td>
<td>7.13</td>
</tr>
<tr>
<td><strong>Percent of GDP at Market Prices</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>1.00</td>
<td>1.33</td>
<td>1.81</td>
<td>2.11</td>
</tr>
<tr>
<td>Health &amp; Population Planning</td>
<td>0.66</td>
<td>0.70</td>
<td>0.90</td>
<td>0.97</td>
</tr>
</tbody>
</table>

Notes and Sources:
Based on the official “revised budget” figures as reported in Bangladesh Economic Survey, Ministry of Finance, various issues.

The analysis of benefit incidence shows that the distribution of benefit from public spending on both health and education among households is weakly pro-poor; that is, the distribution is more equal than the overall income distribution in the economy, although it favours the relatively rich. Only expenditure on mother and child health and on primary education is strongly pro-poor, so that the poor gets more absolute benefit than the rich (World Bank 2003). There is also much inefficiency and wastages in the delivery of public services in these social sectors (Mahmud 2002). Clearly, ensuring adequate access of the poor to education and health services of sufficient quantity and quality requires much more than allocating more budgetary resources to these sectors. Moreover, the structural shift in the budget towards larger social spending has come about from a redefining of the role of the government and is, therefore, of a once-and-for-all nature. In future, higher allocations to social sectors will require more difficult reforms, for example, in respect of preventing tax evasion or downsizing the government. Nevertheless, it must be acknowledged that public expenditure policy of Bangladesh deserves credit for raising the share of these sectors in total budget, and also for implementing at least a weakly pro-poor stance in the distribution of benefits.

Governance, Political Incentives and Policy-making

It is generally agreed that economic reforms in Bangladesh have not been matched by progress in building the institutions of political and economic governance. The degree of resistance to reforms of different kinds depends on the nature of prevailing political cultures. Bangladesh has successfully implemented many reforms that are usually considered as unpopular and vote-losing, such as the withdrawal of agricultural and food subsidies affecting large sections of the population. Considerable progress has also been made in implementing reforms that are liable to antagonise organised militant groups who can create short-term disruption through agitation, such as the trade unions resisting
the privatisation of state-owned enterprises. The successive governments have pursued more or less the same economic reform agenda, even though with varying intensities and often under the leverage of aid conditionality.

The most politically challenging reforms have been the ones aimed at dealing with a whole range of governance-related problems: wilful default of bank loans, large-scale tax evasion, electricity pilferage, corruption in public procurement, deteriorating quality of public administration, poor law and order, inadequate justice system, and erosion of integrity of most other state institutions. These problems are largely related to the country’s core governance systems as shaped by the nature of its politics. Political power has been concentrated in two major parties (e.g. the BNP and the Awami League), which has helped to form governments with large stable majorities; but this has also resulted in a system in which winners in elections take all and the losers have difficulty in reconciling themselves to their loss. The result is a dysfunctional Parliament and a highly confrontational nature of politics. There is little democratic practice within the major parties, which are run by authoritarian control from the top; this is a reflection of the personalised and patron-client relationships pervading the Bangladeshi society at large (Ahsan 2005, Ahmed 2005).

The above structure of governance provides an ideal breeding ground for corruption through the exercise of large discretionary powers with little accountability. Spoils and privileges are parcelled out to different clientele groups as an essential tool of political management. On top of this, a large part of the bureaucracy is seen to be corrupt and incompetent, which further feeds this vicious cycle of poor governance.

In spite of the adverse governance environment, there is ample evidence that the government is committed to play a major developmental role. For example, it cannot be said that the economic reforms discussed earlier were implemented entirely through the leverage of aid conditionality; these have resulted to a large extent from the government’s own commitment for achieving higher economic growth and alleviating poverty. A clue to this can be found in the preparation and presentation of the national annual budgets. In order to have political legitimacy, the announced budgetary measures need to be seen to conform to these broad economic objectives while the rationale of the proposed economic reforms also needs to be spelled out. This is reflected in the policy statements made by the finance ministers at the time of presenting the budgets. While these statements may have a populist stance to an extent (e.g. well justified measures for increased tax coverage are underplayed, while not-so-justified writing-off of agricultural loans is highlighted), at least they show the compulsion on the part of the government to portray the so-called “benevolent social guardian” image. In other words, any deviant political motives or compulsions have to remain as hidden agenda, only to be pursued at the time of implementation of the budget.

Certain yardsticks for judging the merits of the budget proposals are now generally accepted in Bangladesh. One such yardstick, for example, is whether there is enough fiscal prudence to contain inflation and ensure economic stabilisation. Raising higher revenue and containing the growth of administrative expenditures, so as to
generate more domestic resources for development spending, are regarded as a broad goal of budgetary measures. Within development spending, the higher is the benefit seen to be going to the poor, the better. And there seems to be a compulsion for the Finance Minister to show (even with some jugglery of data, if needed) that the allocations to education are larger than the defence budget.

Even if the delivery of public services suffers from serious governance problem, the government has shown genuine commitments to improve social development indicators, such as child mortality, primary school enrolment and the adoption of modern birth control. Support from external donors has definitely helped to achieve these goals, but it cannot be said that the budgetary allocations and other public measures for achieving these goals have been dictated to any large extent under aid conditionality. The government also appears to have been genuinely committed to rural development and poverty reduction as indicated by increased spending and expansion of various schemes to achieve such goals. The government has not only had a record of good disaster management at times of, say, severe floods, but it has also shown sensitivity to reported incidence of seasonal poverty in certain poverty pockets.

A question remains why were some reforms possible and others not. The answer to this lies in analyzing the kinds of reforms that were implemented. Broadly speaking, in selecting reforms successive governments have pursued the path of least confrontation and adopted reforms that were more in the nature of easy wins and “a stroke of the pen” type. Thus, most reforms in the area of macroeconomic management were easy to implement. For example, the country’s bad experience with poor macroeconomic management during the 1972-75 period in terms of runaway inflation created the political support for tightening macroeconomic management. Successive governments since that experience have found it easy to implement the macroeconomic reforms with support from the Bretton Woods institutions. Similarly, the disastrous experience with nationalization and controls in this period was easy to dismantle because most people (except possibly trade unions) saw the merits of doing away with a controlled economy and move towards a private-sector led development strategy. As well, the support for social spending and alliances with NGOs was seen as a political win-win since the results of these interventions were generally beneficial to the interest of the political parties. Parliamentarians could take credit for the expansion of health and education programs in their constituencies that was good for their vote bank while also such spending provided business opportunities for their clients.

It is also important to note that by and large Bangladesh did not see any significant reversal of reforms even as governments changed because the underlying

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23 For example, the multi-donor supported Health and Population Sector Project (1998-2003) stipulated that a minimum of 60 percent of the entire sector’s public expenditures must go to essential healthcare including reproductive health. However, it turned out that the government’s previous patterns of health expenditures had already met this criterion. Similarly, the allocations to primary education within total public education expenditures have been high, more than 40 percent, without any conditionality imposed by donors. For a discussion on these issues, see Mahmud (2002); Mahmud and Mahmud (2000).

24 This is evident from the recent initiatives taken by the government to mitigate seasonal poverty, locally called "monga," in some vulnerable areas in the north-western part of the country.
reforms in macroeconomic management, private sector development and social development were win-win for both the large parties (Awami League and BNP). However, the relative emphasis on specific policies and interventions did differ significantly. Thus Awami League, whose vote bank tends to be more populated by rural residents and low income groups, maintains a more populist and left-wing stance in its policy interventions reflected in greater support for rural spending, is more prone to defend subsidies, and is less enthusiastic about privatization and trade liberalization. The BNP on the other hand is relatively more dominated by urban and business interests and therefore has been more hawkish on pro-market reforms. Where governments of both parties have hesitated is in reforming institutions and core governance concerns largely because of conflict with the fundamental interest of the party members and their leadership. They have also hesitated in taking tough actions where they feared backlash from the voters (e.g. adjustment of energy prices, privatization of ports and public utilities).

The congruence of interest between supporting public goods and the Parliamentarian’s political agenda of creation of vote banks through the control over the delivery of public services has not been an unmixed blessing. The Members of Parliament, instead of being concerned with lawmaking and national policies, become lobbyists for procuring projects for their respective constituencies - by no means a healthy process of selection of development projects. Much of the wastage in public resource management at the local level, such as the alleged leakage of resources in the rural works programme, is the result of the above system. It also partly explains many weaknesses in the implementation of local development projects, which nonetheless has benefited the local communities. The confluence of public good and political incentives is thus at best partial.

The developments in the banking sector provide an example of how the opposing compulsions of patronage politics and sound economic order have worked out to shape policies. The banking sector has long been suffering from the widespread culture of wilful default in loan repayment. The reasons for loan default on such a large scale have been many, such as politically-influenced loans given by state-owned banks, ‘insider’ loans given by private banks to their sponsor-directors, and the weakness of legal provisions for loan recovery. The adverse economic effects of such fiduciary indiscipline gradually took unsustainable proportions and created widespread public resentment. Public opinion against loan defaulters was reflected in the introduction of a law in 1996 debarring such defaulters from participating in national elections. Bold banking reforms were subsequently adopted to prevent banks from giving more loans to defaulters, to

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25For example, as noted earlier, disproportionately more funds are allocated for constructing new local roads rather than for the maintenance of the existing ones; the former is perceived as public service rendered by the local Member of Parliament, the latter as only the routine work of the concerned government agencies.
remove unscrupulous sponsor-directors from the boards of the private banks, and to make the state-owned banks more disciplined and autonomous for their eventual privatisation.26

One worrisome development in Bangladeshi politics that has further complicated the reform of governance is that business interests have gradually gained influence over politics. The first Parliament of the country had few members whose principal occupation was business (politicians traditionally coming from the profession of law); the latest Parliament was, however, dominated by businessmen. This transformation in politics has had an important impact on the policy-making process27. A Parliament dominated by businessmen would try to enact or prevent laws in order to protect their sources of income, legal or illegal. It was only because of the pressure of public opinion that the legislature had to ultimately pass laws against the defaulters of bank loans. But the domination of business interest has meant that implementation of this law in the actual electoral process is largely ignored. There are also many examples that the illegal incomes earned by the businessman-turned-politicians from exercising their political influence later found ways into legitimate businesses. One potential advantage of businessmen-turned-law makers having more political clout is the effective pressure they can create for promoting their legitimate interests, such as in terms of provision of power and better infrastructure including port facilities. But this advantage is gainful only if the conflict of interest between law-making and pursuit of personal business can be managed through appropriate electoral reforms.

It would appear that public economic functions are affected by both adverse and beneficial political incentives. Given the weaknesses of the democratic institutions, there is hardly any effective oversight mechanism to ensure the accountability of the government’s fiscal operations and other economic functions. However, the national elections since 1991, held under a unique system of non-party caretaker government, have been seen as fair and credible. This has created an incentive structure in which public representatives try to respond to the genuine popular sentiments in order to win re-election while still engaging themselves in rent-seeking activities. There also seem to be at work some non-institutional mechanisms for ensuring public accountability, such as through civic activism, a free press and widespread political awareness among the people at large. This probably explains why, in spite of many perverse political incentives embedded in the system, governments have played overall an effective developmental role.

IV. Explaining the “Development Surprise”

Bangladesh’s impressive record of economic growth and social development has been achieved despite apparently poor governance. Bangladesh is thus an outlier in cross-country comparisons relating governance to economic growth.28 Recent studies show

26 Because of actions taken by the central bank, 54 sponsor-directors of private banks lost their directorship for defaulting on loans taken from their banks and 73 others regularized their loans.  
27 See, for example, Mahmud (2002a), Chapter 9.  
28 World Bank (2007), Volume II: Main Report, Chapter 7 and Figure 7.
increasingly compelling evidence that good governance matters to growth, although there are many controversies surrounding these studies regarding the definition of “good governance”, the biases in perception of governance, the direction of causality, and the problem of isolating the effects of country-specific institutional and other factors in explaining cross-national variations. While it is quite evident that Bangladesh’s economic performance has been negatively affected by some of the adverse governance factors, the more interesting question relates to why the country’s economy has performed in the way it has despite wide-ranging governance failure.

Deconstructing Growth

To understand Bangladesh’s development conundrum, one needs to deconstruct the economic growth process and focus on the main drivers behind accelerated growth. As discussed earlier in this paper, the acceleration of growth of the Bangladesh’s economy since the early 1990s has been underpinned by strong export growth, led almost entirely by the growth in readymade garment export. The garment industry has flourished in Bangladesh because of the confluence of a number of favourable factors: the early relocation of garment producers and marketing intermediaries from East Asian countries (especially South Korea) to Bangladesh to evade import quotas in the US and European markets; easy transfer and spread of garment-industry-specific managerial and production skills; preferential access of Bangladesh’s garment export in the major markets of the West; favourable macroeconomic management including a flexible exchange rate policy and other policies adopted by the government in supporting the industry, specially by creating a set of enclave-type arrangements (e.g. bonded warehouses and back-to-back L/Cs to facilitate duty-free import of fabrics); and the abundance of low-cost female labour. Once the growth of the industry gathered momentum and became the main exchange earner, it gained in efficiency and could exercise more clout in shaping government policies in its favour.

The uniqueness of the garment industry in Bangladesh is demonstrated by the fact that other potential exports have not fared well even when generous government support has been provided to them. Besides various export-promoting schemes like the duty drawback system for imported inputs, cash incentives up to even 30 percent of the export value have been provided to certain export items without producing notable results. It is true that even the garment exporters complain about having to pay bribes to facilitate export formalities at the port, besides having to deal with other constraints like inadequate infrastructure. But the industry’s early foothold has helped it to withstand these constraints.

Strong export growth has contributed to GDP growth both directly and indirectly by providing growth stimulus to other parts of the economy. There is also an indirect route through which export growth, coupled with import liberalisation, has helped the

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29 Easterly (2002, Chapter 8) elaborately describes how, by some historical accident, the Korean firm, Daewoo, and an influential Bangladeshi bureaucrat-turned-industrialist, Noorul Quader, got together to start the process of transfer of knowledge and skills for setting up an export-oriented garment industry.
growth in small-scale and informal sector activities. These later activities produce mostly non-tradable or only poor substitutes or imports. A real devaluation of taka can hurt these activities by increasing the prices of imported inputs and by turning the domestic terms of trade against their products vis-à-vis tradable. But thanks to rapid growth of export and remittances, the real exchange rate of taka has remained more or less stable at a time when there was substantial import liberalisation and a marked decline in external deficits.\(^{30}\)

Besides garment export, growth impulses have come from workers’ remittances and from growth in agriculture and in small-scale industries and services, mostly belonging to the informal sector. The government has pursued policies since the early 1980s to encourage manpower export and attract remittances by negotiating with host countries, offering favourable exchange rates for workers’ remittances during the previous exchange control regime, and facilitating remittances through banking channels by various means. Growth in agriculture has been helped by market-oriented reforms in agricultural input markets as mentioned earlier. Moreover, because both agriculture and informal sector activities mostly remain outside the purview of the government’s regulatory functions, these are likely to be less adversely affected by poor governance compared to the activities in the modern organised sectors of the economy.\(^{31}\)

The growth of the urban centres, foremost among them Dhaka, has greatly contributed to economic growth by creating the complementarities that accompany urban growth. Dhaka, with 12 million inhabitants, has seen an eight-fold increase in its population since 1970 and is reckoned to be among the two fastest growing mega-cities in the world.\(^{32}\) Not least because of the rapid growth of the export-oriented garment industry and the flow of remittances and the related housing construction boom, urbanisation has been accompanied by job creation strong enough to accommodate over 10 million new entrants to the workforce between 1996 and 2003.\(^{33}\) Nevertheless, the problem of poor governance manifests here in the form of unplanned urbanisation creating huge problems for the future.

In the rural areas, the non-farm sector has become more diversified, productive and dynamic, especially with the growth of the rural towns. The clusters of habitation around these rural towns have helped to promote those non-farm activities that can cater to urban-like and income-elastic consumer demand; and these are the kinds of activities that are found to have shown more dynamism within the rural non-farm sector in terms of

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\(^{30}\) During the same period, the currencies of many developing countries, including India and Pakistan, underwent massive real devaluation; see Mahmud (2004).

\(^{31}\) There is, however, evidence that with a deterioration of law and order, small-scale and informal sector activities can be more vulnerable to illegal extortion and toll collection than larger-scale enterprise in terms of the proportionate increase in the cost of doing business; Ahmed and Mahmud (1996), Chap. 2, p. 42.

\(^{32}\) Lagos in Nigeria is the other.

improved technology and higher labour productivity\textsuperscript{34}. Very rapid expansion of microcredit since the early 1990s is also likely to have played an important part in this process.

\textit{Growth Inclusiveness and Poverty Reduction}

With the acceleration in the growth of per capita income, Bangladesh has made considerable progress in poverty reduction. During the 1990s, the national incidence of poverty declined from nearly 60 percent to about 50 percent; and a much more rapid reduction in poverty seems to have taken place in the following five-year period with the national poverty rate reduced to about 40 percent,\textsuperscript{35}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
Year & Percent of population under poverty line & Gini coefficient of consumption expenditure & Urban-rural ratio of per capita expenditure \\
 & Rural & Urban & National & Rural & Urban \\
\hline
1991/92 & 61.2 & 44.9 & 58.8 & 0.24 & 0.31 & 1.65 \\
2000 & 53.0 & 36.6 & 49.8 & 0.27 & 0.37 & 1.87 \\
2005 & 44.5 & 28.8 & 40.6 & 0.28 & 0.35 & 1.67 \\
\hline
\end{tabular}
\caption{Trends in Poverty and Income Distribution in Rural and Urban Areas, 1983-84 to 2005}
\end{table}

Notes: The poverty estimates are those of the Bangladesh Bureau of Statistics relating to the “upper poverty line” and derived from a cost-of-basic-needs methodology. The Gini coefficients are estimated by adjusting per capita income for spatial price variations; but urban-rural ratios relate to nominal per capita consumption expenditure.


More progress against poverty would have been made in the 1990s had income distribution not worsened in both rural and urban areas. In the recent periods, growth acceleration in many developing countries, including in South Asia, has been accompanied by increased income inequality (Devarajan 2005, Ahmed 2006). The growth-inequality links in the case of Bangladesh seems to be, however, of a different nature. The pattern of growth in Bangladesh would appear to be fairly pro-poor—with the main stimulus to economic growth coming from labour-intensive garment exports, micro- and small-scale enterprises in manufacturing and services, and remittances from migrant workers. All these sectors typically provide scope for upward economic mobility for the poor. Even then, inequality tended to increase because the more dynamic parts of the economy happened to be the ones with relatively unequal income—such as the urban/organized sector vis-à-vis the rural/informal sector or the dynamic part of the rural non-farm sector vis-à-vis agriculture—and also because growth, though employment-intensive, was not strong enough to pull wages in the vast agricultural and informal labour markets.\textsuperscript{36}

\textsuperscript{34} Mahmud (2002a), Chapter 4.
\textsuperscript{35} The official poverty estimates are made with reference to an “upper” and a “lower” poverty line. The national poverty incidence, according to the lower poverty line is estimated to have declined from 43 percent in 1991/92 to 34 percent in 2000 and 26 percent in 2005.
\textsuperscript{36} Ahmed and Mahmud (2006), Chapter 2; Osmani et al. (2003).
However, the estimates for the most recent period from 2000 to 2005 suggest that the process of increasing income inequality has slowed down or even reversed; as a result, the impact of income growth on poverty reduction has been much more pronounced during this period than in the 1990s (Table 5). The real wages in agriculture and construction – the sectors dominated by informal labour markets – have shown strong upward trends since the end-1990s, after having been stagnant for a long time. It would thus appear that Bangladesh is perhaps past the turning point of the “Kuznets curve” in the income-inequality link.

Recent analyses of poverty dynamics in Bangladesh suggest that, compared to many other developing countries, upward economic mobility in Bangladesh is less constrained by class, ethnicity or other socio-economic barriers. Access to markets with extensive rural transport networks and a very rapid spread of micro credit have contributed towards expanding the economic opportunities for the poor. Study findings show that a large number of households lying above the “poverty line” are susceptible to risks that can pull them down. The other side of the coin must be that the numbers of households who graduate from poverty are many more than what is indicated by the estimated reduction of poverty incidence during a given period. Such inclusiveness may contribute to social cohesion and it also raises awareness about economic opportunities, which may explain why even the poor families are increasingly sending their children to school. But it may also raise people’s expectations and lower their tolerance for governance failure.

Social Development: the Most Striking Development Surprise

Bangladesh’s most striking development surprise is regarding the rapid and spectacular improvements in human development indicators that it has achieved, particularly since the early 1990s. From being a laggard, Bangladesh now outperforms most Indian states and South Asia as a whole in such indicators as female school enrolment, child mortality and contraceptive adoption rates (Table 6). The achievements of Sri Lanka and some Indian states like Kerala in this respect are well known, but the factors behind Bangladesh’s success need a closer look.

How could these achievements be made in spite of still widespread poverty, relatively low though increasing public social spending and the poor governance of

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37 World Bank (2007), Volume II: Main Report, Figure 3.7, p.43.
38 Although the general validity of the Kuznets process has not been borne out by recent cross-country experience (see, for example, Anand and Kanbur 1993), this does not imply that it cannot be valid for specific country situations.
39 This not to underestimate the problem of persistent or chronic poverty in Bangladesh; see Sen and Hulme (2006).
41 For most social development indicators, the actual values of the indicators achieved by the country are found to be far superior to the predicted values at the given level of per capita income; see Government of Bangladesh (2005), Table 1, p. 9.
service delivery systems in Bangladesh? Much of these achievements can be explained by the adoption of low-cost solutions (such as oral dehydration technology for diarrhea treatment leading to decrease in child mortality) and by creating more awareness about, say, immunization or contraceptives or female child enrolment. New ideas catch on rather quickly in Bangladesh, helped by the density of settlements (and their lack of “remoteness”) and effective social mobilization campaigns. Thus far, Bangladesh has not really followed the typical pathways to human development: the income-growth-mediated path as in South Korea or the public-spending-driven path of, say, Sri Lanka. But further progress will need following either or both of these paths, as the gains from low-cost easy solutions are reaped and the amount of public spending, quality of services and synergies with income-poverty all become important.

**Table 6. Improvements in Some Human Development Indicators since 1990, Bangladesh and South Asia**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bangladesh 1990</th>
<th>South Asia 1990</th>
<th>Bangladesh 2002-2004</th>
<th>South Asia 2002-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross primary enrolment rate (%)</td>
<td>80</td>
<td>95</td>
<td>109</td>
<td>103</td>
</tr>
<tr>
<td>Ratio of girls to boys in primary and secondary education (%)</td>
<td>77</td>
<td>71</td>
<td>107</td>
<td>89</td>
</tr>
<tr>
<td>Under-5 mortality rate (per 1,000 live births)</td>
<td>144</td>
<td>130</td>
<td>69</td>
<td>86</td>
</tr>
<tr>
<td>Population with access to improved sanitation (%)</td>
<td>23</td>
<td>20</td>
<td>48</td>
<td>37</td>
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</tbody>
</table>

*Sources:* Estimates of access to sanitation are from UNDP’s *Human Development Report 2005*; all other estimates are compiled from the World Bank’s *World Development Indicators* as reported in World Bank (2006) and World Bank (2006a).

**Unbundling Governance**

The governance-growth nexus needs to be understood in the individual country contexts, in which institutions, the historical and cultural settings and the stage of development will matter. Most international comparisons show relatively very poor perceptions of governance in Bangladesh. For example, in the most recent governance data set released by the World Bank Institute for 2005, Bangladesh’s ranking among 210 countries varies from bottom seventh to thirty-second percentile in the six indicators: 6.6 for political stability, 14.9 for regulatory quality, 19.8 for rule of law, 7.9 for control of corruption, 21.1 for government effectiveness and 31.4 for voice and accountability. Bangladesh’s
position is significantly worse compared to its South Asian neighbours in most indicators; only in respect of voice and accountability, it is ahead of Nepal and Pakistan. The information from the surveys on *Investment Climate* and *Doing Business* carried out by the World Bank Group is also not encouraging for Bangladesh in most respects.\footnote{World Bank (2007), Volume II: Main Report, Chapter 7.} Even more discouraging is Bangladesh’s very poor ranking in the economic competitiveness index prepared by the World Economic Forum.\footnote{Bangladesh ranks 98th out of 102 countries in business competitiveness according to the World Economic Forum’s *Global Competitiveness Index*.}

In some respects of governance, however, Bangladesh does well. For example, Bangladesh ranks among the top 50 percent of the countries in terms of the ease of doing business according to the World Bank’s *Doing Business* survey of 2006. It actually ranks above many developing countries in terms of investor protection.\footnote{In terms of investor protection index, Bangladesh scores 6.7 compared to the OECD average of 6.0 and the South Asian average of 5.0.} The perception indices may also neglect many ground-level realities. Although Bangladesh scores very poorly in terms of enforcements of contracts, casual observation suggests that local business people do not regard it as any great hindrance in an environment where such enforcement can be biased to favour them and where informal methods based on business mores and customs and reputation play an important role. The corporate tax regime is relatively liberal in Bangladesh and profits are fairly high in formal sector enterprises.\footnote{The World Bank’s *Doing Business* does not take account of business profitability.}

Bangladesh has in fact enjoyed governance successes in some key areas. The state has created space for the emergence of what is a vibrant domestic private sector. It has done this by various policy reforms aimed at maintaining macroeconomic stability, keeping fiscal deficits low so as not to crowd out bank lending to the private sector, providing access to imported inputs through import liberalisation, increasing competition by reducing entry barriers, and improving the central bank’s oversight functions in respect of commercial banking. The successive democratically elected governments have been able to make relatively wise public expenditure choices. The disaster management capacity of the government has also improved significantly over the years. The state has created space and forged partnerships with NGOs and the private sector to help deliver social services. And there has also been a certain degree of continuity in policy in spite of changes in government. Overall, the state has played a significant developmental role.

**V. Concluding Remarks: Future Challenges**

Bangladesh has been successful thus far in converting the gains of economic stabilisation and reforms into sustained and accelerated growth. To consolidate this process and to meet the risks of slippage, it has to address the emerging challenges on many fronts. The institutional weaknesses may have already reached the tipping point beyond which these may prove to be the binding growth constraints. While the governance environment may have been barely adequate so far to cope with an economy breaking out of stagnation and
extreme poverty, it is increasingly proving a barrier to putting the economy firmly on a path of modernisation, global integration and poverty reduction. Fortunately, Bangladesh’s problem is not to jumpstart growth, but to maintain, and to the extent possible, accelerate it.

The governance agenda is large and cuts across a wide range of institutions and threatens powerful vested interests. Developing a strategic, sequenced approach that relies on success in a few key areas to generate momentum and demand for reform in other areas will be crucial. Compared to the first-generation reforms, there is a need for deeper and more complex policy innovations to deal with the emerging binding constraints to growth, such as the inefficient and overburdened sea-port, inadequate power and infrastructure, urban congestion and mismanagement, acute skill shortages, and limited successes in attracting foreign investments.

Future growth will have to come increasingly more from the urban organised sectors of the economy, which will need a better-functioning regulatory framework and improved provision of infrastructure facilities. Strengthening agricultural growth will also need a modernisation of the marketing infrastructure. The growth in crop agriculture over the past decades has come almost entirely from increased rice and wheat production. Beyond the attainment of self-sufficiency in rice, there is potential to accelerate agricultural growth through crop diversification (Mahmud et al. 2000). High-value crops such as fruits and vegetables could be profitably produced both for domestic consumption and for export, but a shift from rice to such crops will require technological dissemination, better integration with processing and marketing, and provision of other support services. For these products to enter the export market would require even more sophisticated marketing infrastructure.

Strong export growth is key to achieving any impressive growth performance of the Bangladesh economy. Bangladesh has made the transition from being primarily a jute-exporting country to a garment-exporting one. The transition has been dictated by the country’s resource endowment, characterized by extreme land scarcity and a very high population density, which makes economic growth dependent on the export of labor-intensive manufactures. It is not, however, easy for a least-developed country like Bangladesh to specialize in manufactured exports. Having low wage costs can hardly compensate for its relative disadvantage in marketing skills and infrastructure (including transport, ports, product standards, and certification facilities). Thus, Bangladesh’s export base remains low as the impressive success in garment export has yet to be replicated in other industries. Indeed, Bangladesh’s experience with the garment industry has demonstrated the limitation of relying on enclave-type arrangements to facilitate export growth in a specific activity, while postponing institutional reforms for improving the investment climate generally.

Bangladesh’s labour force has been increasing at a rapid rate because of the age composition of the population resulting from a demographic transition and also because of a rapid increase in the female labour force participation rate. This is a potential strength of the economy, but enough jobs need to be created to reap the economic gains
from it. A slackening of the labour market will keep wages from rising and may lead to political discontent. The garment industry is already facing labour agitation demanding higher wages. Bangladesh also needs more skilled and well-trained workers to boost productivity, and with it, global competitiveness. Improved governance of the education system will be needed to raise the quality of education and consolidate the earlier gains from the increase in primary school enrolment.

Bangladesh needs foreign direct investment (FDI) for facilitating technology transfer and for meeting the resource needs. Local entrepreneurs may have got used to dealing with many aspects of the governance problems, but this is not true for prospective foreign investors. Besides the export-oriented garment industry, FDIs have mainly come in sectors like electricity generation and exploration and production of natural gas which involve purchase or sale contracts with the government at “administered” prices. Because of the perceived high country risk for investment in Bangladesh, the prospective foreign investors include a high premium in their profitability calculations, so that the negotiated terms are less favourable to Bangladesh than they otherwise could be.

Can governance problems be addressed by creating certain pristine islands of honesty in an otherwise governance-challenged environment? There are already a few institutions of this type in Bangladesh, such as in microfinance (PKSF), rural infrastructure (LGED) and rural electrification (REB). Also, by and large, the Central Bank and the Ministry of Finance has functioned relatively efficiently and have served as the main reform champions in the government. In each of these cases, there was a confluence of many factors contributing to the success of the respective institutions such as strong leadership, better quality staffing and a degree of autonomy and ownership that provided a kind of “ring-fencing” from adverse outside interferences. The record of replicating such institutional innovations has proved discouraging. There also no guarantee that the so-called islands of excellence will continue to remains so. The REB, for example, has recently suffered serious setbacks because of politicisation of its rural co-operatives; but the rot really started from the top with changes in its leadership.

The favourable factors that helped to create the above kind of institutions cannot be planned or predicted. From the policymakers’ point of view, a more effective approach may be to move slowly and steadily in certain strategic areas of institutional reforms so as to remove the binding growth constraints. In such effort, policymakers need to be patient and opportunistic instead of having an ideal design.

Without some political incentives, however, attempts at institutional reforms are unlikely to have much success. As mentioned earlier, the reforms in the banking sector could make progress in spite of strong vested interests because the government realised the key importance of such reforms in maintaining a sound economic order. In some other key sectors, however, such incentives have not worked. In power generation, potential private investors have been put off by the interference of vested interests in the tendering and negotiation process. The result is an acute power shortage that has not only proved to be a brake on economic growth but also a source of great embarrassment for the erstwhile BNP government. Successive governments have also neglected to improve
the management of the Chittagong port, which suffers from the corruption in the customs procedures, deficient logistical capacity and the interference of highly politicised labour unions. As a result, the only major sea-port of the country ranks among the world’s least efficient container ports. The recently installed non-party caretaker government is now beginning to address some of these shortcomings.

Bangladesh’s economic growth prospects will ultimately depend on the viability of its core systems of political governance. Will political governance improve through increased civic activism and a lower tolerance shown by the public for weak governance? Or, will there be a “path-dependent” institutional deterioration as postulated by Douglass North?46 Bangladesh’s recent political developments show both these tendencies. On the one hand, there is no evidence of as much elite capture of the system as one would expect from the country’s image of being one of the most corrupt and ill-governed countries. On the other hand, patronage politics as exists in Bangladesh seems to have resulted in more and more rent-seeking as an essential means of political management, thus rendering the system increasingly unsustainable.47 Also, the politics of confrontation, along with a winner-takes-all system, has increasingly raised the stakes in winning elections. As a result, after three reasonably fair elections since 1991, the elections scheduled for late 2006 had to be postponed under the threat of extreme political unrest. This has prolonged the tenure of the present non-party caretaker government and has broadened its mandate beyond holding the elections. The popular expectations are that this government will bring about the necessary institutional changes to put the governance framework on a proper footing again.

References

To be added

46 See, for example, North (1997).
47 Economic reforms have no doubt contributed to decrease the scope of rent-seeking, such as from the import licensing system. New laws of public procurement have been introduced to make the public procurement system more transparent and accountable, but the system has hardly worked. Moreover, financial extortion (including illegal collections of tolls and protection money) under political patronage has been an increasing phenomenon contributing to the cost of doing business. Overall, one could thus conclude that if there is a demand in the political system for illegal incomes and rent-seeking, economic reforms alone will not be the remedy, see Mahmud (2001), Chapter 3.