

CHAPTER 7: GOVERNANCE AND GROWTH: THE BANGLADESHI CONUNDRUM¹⁴⁴

I. Introduction

7.1 Bangladesh's impressive record of economic growth and social change has been achieved despite weak governance, particularly high levels of corruption and a perceived worsening of regulatory quality. Bangladesh is thus an outlier in cross-country studies which relate governance to economic growth. What explains this relatively strong performance despite apparently poor governance? And would this performance be better and more sustainable if governance were better? This chapter attempts to grapple with these questions. Although there are no clear answers, the cost to growth and social development from poor governance is clear enough.

7.2 The chapter begins with a brief overview of whether governance matters to growth. It summarizes what we know about the quality of governance in Bangladesh. Governance is then unbundled in an effort to demonstrate that Bangladesh's governance also has some positive aspects to it although these often not recognized by observers. The chapter then focuses on the negative aspects that adversely affect growth. It concludes by arguing that building on its many successes and addressing these negative governance factors could help remove some of the constraints that are preventing Bangladesh's growth performance coming closer to its faster growing neighbors.

II. Does Governance Matter to Growth?

7.3 ***Research over the last decade has shown increasingly compelling evidence that good governance matters to long-run growth.*** This research has included economic history studies of development over the last millennium as well as cross-country studies that have tested the statistical relationship between governance and growth.¹⁴⁵ One study shows that absolutist governments were associated with slow growth of cities in the 800 years preceding the industrial revolution.¹⁴⁶ Large cross-country studies have shown that political instability adversely affects property rights,¹⁴⁷ and that subjective assessments of political risk to overseas investors provided by commercial firms are closely associated with lower investment and growth rates.¹⁴⁸

7.4 ***These statistical relationships do not say much about the direction of causality. Governance may have simply improved as income levels increased. More recent studies have attempted to address this weakness.*** A recent comprehensive study asks what the independent contribution of geography, integration and institutions is to the cross-national variation in income level, and concludes that institutions trump everything else. Once institutions are controlled for, global integration has no direct effects on incomes, while geography has at best weak direct effects.¹⁴⁹ A recent World Bank staff report also attempts to address the causality issue by measuring long-term growth during periods entirely

¹⁴⁴ This chapter draws on a discussion of the Governance conundrum in the recent World Bank Group's "Country Assistance Strategy for the People's Republic of Bangladesh for the Period FY-06-09", Report No. 35193 dated February 6, 2006, Washington D.C.

¹⁴⁵ Governance is broadly defined in these studies to mean the exercise of power through the country's economic, social and political institutions. These include the processes by which governments are chosen and replaced, held accountable and monitored, the capacity of government to formulate and implement policies and manage resources efficiently, and the respect with which citizens hold the institutions that govern social and economic interactions among them.

¹⁴⁶ De Long, J. Bradford and A. Shleifer (1993).

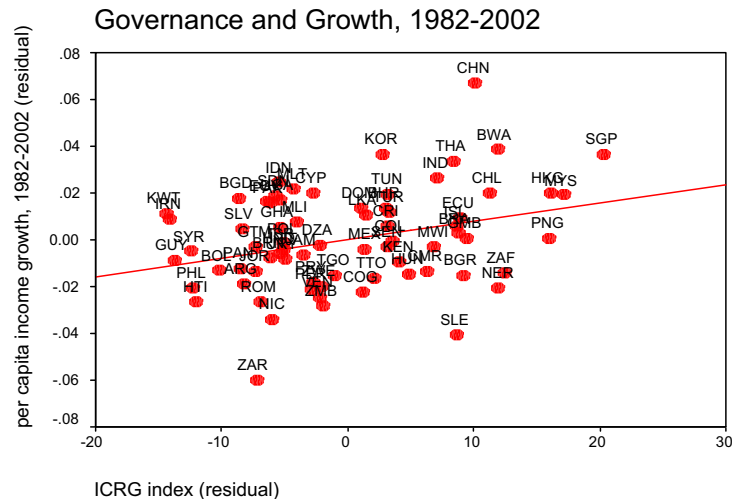
¹⁴⁷ Barro, Robert (1991).

¹⁴⁸ Knack, S., and P. Keefer (1995).

¹⁴⁹ Rodrik, D., Subramanian, A., and F. Trebbi (2002).

subsequent to when the quality of governance assessments were made (Figure 7.1). The strong relationship between governance and growth remains, and is not very sensitive to whether developed countries are included in the sample or not, although it becomes slightly weaker if countries in the East Asia and Pacific Region are excluded.

Figure 7.1: Governance and Growth



Note: The scatterplot in Figure 7.1 shows the partial relationship between the quality of governance in 1982 and income growth in the subsequent two decades (controlling for schooling levels and initial income levels) for all countries for which data was available except 22 developed countries. (Global Monitoring Report, World Bank, 2006).

7.5 ***The conclusions reached by these studies are not uncontested.*** The studies rely heavily on subjective indicators, since objective indicators that measure constrained behavior are almost by definition impossible to find. And objective indicators that measure intent but not practice are meaningless.¹⁵⁰ It is also argued that subjective indicators are prone to ideological biases and overgeneralizations on the part of businessmen surveyed. The effects of recent incidents may overly affect judgments by citizens and businessmen. And those surveyed are often part of a small group of “country watchers” who tend to talk to each other and are influenced by each other. Moreover, respondents to such surveys may confuse cause and effect. A strong growth performance may lead some to assume strong underlying governance (as with East Asia during the 1980s and early 1990s), while ignorance about strong development gains in countries that are not the focus of much international attention except during times of crises may lead to the opposite conclusion (e.g., Bangladesh). Moreover, indicators typically used, such as the protection of property rights, may be unduly influenced by non-institutional factors such as the emergence of civil unrest.

7.6 ***However, there is steady progress in improving the quality of governance data and particularly in the design of questionnaires eliciting the views of businessmen and citizens to reduce the noise in the data.*** Moreover, the users of this data are well aware of these issues and have been taking increasing pain to deal with the underlying concerns through a range of statistical techniques.¹⁵¹ Above all, perceptions become the reality, influencing as they do behavior and, particularly, investment decisions of foreigners, and therefore need to be taken seriously.

7.7 ***That we have evidence that governance matters to growth however tells us little about why it matters and how it influences growth.*** The cross-country studies have failed to establish a causal link

¹⁵⁰ See Weyland, Kurt (2003).

¹⁵¹ See Kaufmann, Daniel, Kraay, Aart and Mastruzzi, Massimo (2006).

between particular forms of institutions and economic growth. As academic Dani Rodrik observes, “we know that growth happens when investors feel secure, but we have no idea what specific institutional blue prints will make them feel more secure in a given context”.¹⁵² Certainty of property rights is clearly important to investors, but this implies nothing about the form that property rights should take.¹⁵³ Problems of identifying appropriate policy prescriptions are accentuated by less than full transparency in the criteria, information sources and methodology used by risk assessment firms. For example, it is possible that countries are only downgraded for violations of property rights that the risk assessors deem to be harmful to growth. If so, an exclusive emphasis on the security of (all) property rights might actually reduce growth in the (admittedly few) developing countries with growth-oriented high-capacity governments that might otherwise re-allocate rights in ways that are favorable to long-run growth.^{154, 155}

7.8 *Understanding individual country contexts and how institutions work in particular historical and cultural settings is important to understanding better the governance-growth nexus.* This chapter is an attempt to improve our understanding of this relationship in the particular context of Bangladesh, where the economy has seen an impressive growth performance despite poor governance.

III. Bangladesh’s Mixed Record of Governance

7.9 *Bangladesh’s strong growth and macro-economic performance highlighted in Volume I of this report contrasts sharply with the relatively poor perceptions of governance in the country.* In the most recent governance data set released by the World Bank Institute (WBI) for 2005,¹⁵⁶ Bangladesh scores poorly on all six indicators, ranking between the bottom seventh to thirty-second percentile among some 210 countries (**Figure 7.2**). Bangladesh’s percentile rankings were, respectively, 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. Within the South Asia region, with at a confidence level of least 90 percent, Bangladesh fared worse than India on each of the six indicators and Sri Lanka on rule of law and control of corruption, and better than Nepal and Pakistan on voice and accountability.

7.10 *A comparison of the point estimates for these indicators over time suggests that Bangladesh’s performance has worsened on all six indicators between 1998 and 2005.* However, because of large, though declining, margins of error, there is not enough evidence to conclude that Bangladesh’s governance has become better or worse, except in the case of *political stability*, where it is possible to say at a 90 percent confidence interval that there was a perceived decline. On both *control of corruption* and *regulatory quality*, there is at least 70 percent chance that there was deterioration over time

¹⁵² Rodrik, Dani (2006).

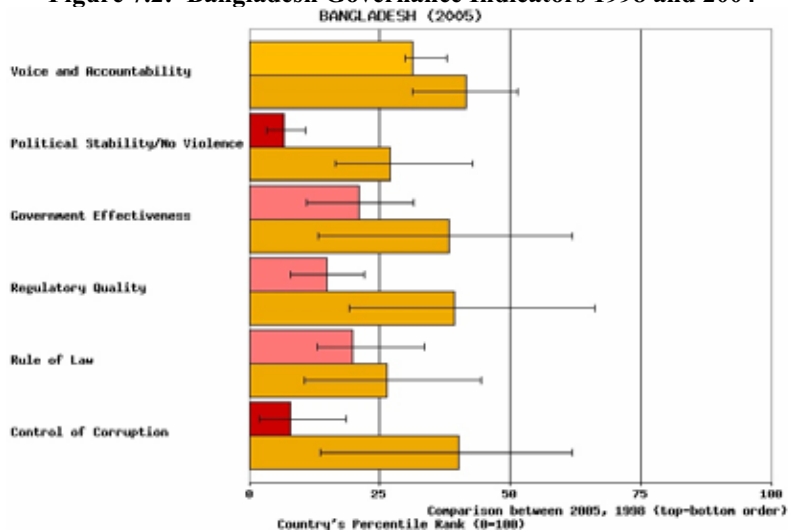
¹⁵³ Rodrik, et al (2002), cite the experience of China and Russia: China retains a socialist legal system, while Russia has a formal property rights regime in place. Yet Russia scores lower than China in property rights indicators. Credibly signaling that property rights matters is more important than having formal property rights on paper, they conclude.

¹⁵⁴ Khan, M (2002).

¹⁵⁵ For example, land reforms in Taiwan and Korea are often credited in part for their subsequent economic success.

¹⁵⁶ The increased awareness of the importance of institutions to development outcomes has been accompanied by a large body of work to measure the quality of governance in different countries. The WBI has developed a set of indicators aimed at capturing these broad dimensions of governance. These indicators aggregate a large number of surveys of businesses, citizens and experts both within and outside countries to measure performances in six key dimensions of governance: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.

Figure 7.2: Bangladesh Governance Indicators 1998 and 2004



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2006: *Governance Matters V: Governance Indicators for 1996-2005*.

7.11 *While these data rely on perception-based surveys, the storyline that emerges is reinforced by the data emerging from surveys on Investment Climate* (done jointly by the World Bank and the Bangladesh Enterprise Institute) *and Doing Business* (done by the World Bank) that rely on opinions based of those actually engaged in business in Bangladesh. While subjective bias is likely even here, the information collected also records specific data on costs associated with governance.

- Investment climate survey data from 2002 (Table 7.1) show the bureaucracy delivering in some areas and not in others. *Senior management time spent dealing with requirements of regulations* is a modest 4 percent, just over half the regional average, while enterprises on average find a much higher level of *consistency of officials' interpretation of regulations* than in South Asia or all countries surveyed. Yet, Bangladesh enterprises report almost twice the level of concern with *economic and regulatory policy uncertainty* than in South Asia as a whole. Similarly *tax administration* was seen as a major or severe obstacle by half the firms surveyed, double the global average and more than double the South Asian average, while *customs and trade regulations* also received poor ratings with 42 percent of firms seeing this as a major or severe obstacle.
- Corruption is clearly a major concern. Some 58 percent see *corruption* as a major obstacle, as against a global average for the survey of 30 percent and a South Asia region average of 25 percent. Corruption is thus the second most important source of concern for investors in Bangladesh. Some 86 percent of firms expect to give gifts in meetings with tax inspectors, almost twice the level for South Asia as a whole
- *Lack of confidence in the judiciary* among Bangladeshi enterprises at 83 percent of the firms surveyed was the lowest rating among all countries surveyed. *Crime, theft and disorder* were seen as a major or severe obstacle by 39 percent of firms, again substantially higher than in the region as a whole (15 percent) and globally (20 percent), although the actual cost of such losses was around the South Asia average (0.6 percent of sales).

Table 7.1: Investment Climate Survey

Indicator	Bangladesh	South Asia	All Countries
Senior Mgmt time spent dealing with regulation requirements (% time)	4.2	8.1	8.2
Officials' interpretation of regulations, predictable (% agree)	78.6	52.5	46.9
Economic and regulatory policy uncertainty (%)	44.3	23.2	30.5
Firms expected to give gifts in meetings with tax inspectors (% of firms)	85.8	44.3	21.7
Unofficial payments for firms to get things done (% of sales)	2.5	1.6	2.4
Value of gift expected to secure government contract (% of contract)	4.3	2.2	3.0
Corruption as a major or severe obstacle (% of firms)	57.6	25.3	29.9
Confidence in the judiciary system (% of firms)	17.02	48.5	56.7
Crime, theft and disorder a major or severe obstacle (% agree)	39.0	15.0	19.7
Losses due to crime (% of sales)	0.6	0.6	1.5
Tax administration a major or severe obstacle (% of firms)	49.7	22.4	25.9
Customs and trade regulations a major or severe obstacle (% of firms)	41.9	24.8	16.8

7.12 Information from the World Bank's *Doing Business* 2006 database is also not encouraging (Table 7.2) overall. There are more procedures involved and it takes more time to start a business in China than in Bangladesh, and yet the associated cost in China is half that in Bangladesh. Once firms are established they are subject to frequent visits from a variety of government agencies (some 17 a year on average in 2003 compared to some 7 a year in India in 2004). The number of procedures and their time requirement for registering a property is among the highest in the world – it takes less than one-fifth as much time to register a property in the median LIC as in Bangladesh. Bangladesh does a bit better on contract enforcement, where the number of procedures, time, and cost involved are each lower than in India, Pakistan and the median LIC. Exporters need a lot of signatures, which take a long time (35 days on average, compared with 20 days in China) and undercuts competitiveness of Bangladeshi exporters. Recovering a loan in a bankruptcy can take up to 4 years and cost up to 8 percent the value of the estate, with the recovery rate a low 24 cents on the dollar.

Table 7.2 Cost of Starting a Business in Bangladesh and Comparator Countries

	Starting a Business			Registering a Property		Enforcing Contracts			Export Procedures		
	Procedures	Time (days)	Cost (US\$)	Procedures (number)	Time (days)	Procedures (number)	Time (days)	Cost (% of debt)	Documents (number)	Signatures (number)	Time (days)
Bangladesh	8	35	358	11	363	29	365	21.3	7	15	35
China	13	48	175	3	32	25	241	25.5	6	7	20
India	11	71	383	6	67	40	425	43.1	10	22	36
Malaysia	9	30	972	4	143	31	300	20.2	6	3	20
Pakistan	11	24	146	5	49	46	395	35.2	8	10	33
Sri Lanka	8	50	105	8	63	17	440	21.3	8	10	25
Thailand	8	33	155	2	2	26	390	13.4	9	10	23
LIC Median	10	44	372	6	71	34	390	31	8	13	43

Source: *Doing Business Indicators 2006*, World Bank.

IV. Unbundling Governance in Bangladesh: Some Strengths

7.13 How has Bangladesh enjoyed such relatively strong economic outcomes with such poor governance? *The mixed record of governance shown above suggests however that Bangladesh has enjoyed governance successes in some key areas.* There are at least five areas where Bangladesh has unquestionably demonstrated a capacity for good governance.

7.14 *First, the state created space for the emergence of what is a vibrant domestic private sector.* It has done this in part by increasingly introducing macroeconomic discipline, as evident from low inflation rates, fiscal deficits and external indebtedness, thus reducing the crowding out of private sector investment. One aspect of the enhanced macroeconomic discipline is the improved fiduciary regulation of commercial banks by Bangladesh Bank. The Government has also had some success in reducing the

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non-performing loans of nationalized commercial banks (NCBs), a major source of weak governance, by capping new lending to private borrowers, enforcing a ban on loans to defaulters, closing 100 bank branches. These measures have resulted in a sharp fall in the share of the NCBs in total bank lending; from 70 percent in 2000 to under 40 percent today (see **Chapter 8** for details). In addition, the state has opened up the economy through trade liberalization, although, as argued in **Chapter 5**, there remains a strong anti-export bias confronting Bangladeshi producers. Nevertheless, from a long term perspective, trade liberalization and the successful encouragement of garments exports have led to a near doubling in the share of trade in goods in GDP since 1990, contributing to an enlarged role for the private sector.

7.15 *Second, successive governments have encouraged the migration of Bangladeshi workers* to West Asia and other destinations, and created a domestic economic environment that has encouraged these workers to remit large sums of money to Bangladesh. These remittances, which amount to over US\$6 billion a year (including those through informal channels), have in turn stimulated domestic demand in the country side, and financed growth inducing investments in land, agricultural inputs, human capital and business start-ups.

7.16 *Third, Bangladeshi governments have been relatively good at making wise public expenditure choices.* Military spending has been kept under check, and at 1.1 per cent of GDP, is less than half the regional average, leaving fiscal space for pro-poor spending. It has also financed rural infrastructure, particularly roads connecting about 1,400 of 2,100 growth centers and markets and thus also contributing to the significant increase in non-farm incomes. Government budgets have also ensured a sustained if still modest injection of public funds for health and education that have increased the quality of human capital and contributed to the significant strides in attaining the Millennium Development Goals (MDGs).

7.17 *Fourth, the state has recognized its limitations in meeting the strong demand for public services and has created space and forged partnerships with NGOs and the private sector to help deliver social services.* Unlike many developing countries where the state crowds out civil society or co-opts NGOs, Bangladesh has seen the emergence of effective partnerships between large, effective NGOs and the state to deliver micro-credit and to provide education and health services. Bangladeshi NGOs account for just under a tenth of health and education spending. But they have also emerged as major social enterprises with considerable capacity to deliver a range of developmental services that have contributed to both growth and human development. The state has also pragmatically encouraged the private sector to help provide secondary and tertiary education.

7.18 *Fifth, the state has greatly improved its capacity to manage natural disasters.* The macro-economic impact of natural disasters has been considerably reduced. The 1998 flood for instance was far more severe than that of 1988. But per-capita GDP growth stood at 3 percent in FY99, whereas a decade earlier per-capita GDP growth was negative in the flood year.¹⁵⁷ The factors contributing to this improvement include the reduced dependence on farm income, early warning systems, the construction of cyclone shelters, and better relief efforts including reduced leakages in food distribution, allowing private sector imports of food, and well targeted Voluntary Group Feeding systems. The response capability of civil administrations has improved markedly and public campaigns to educate households on food and water safety precautions during floods and cyclones have proved effective. NGOs play a major role in disaster prevention, recovery and relief, and an alert opposition and free press have motivated successive governments to respond promptly to disasters.

7.19 *What is clear from the above is that the State has played a significant role in the growth that Bangladesh has enjoyed.* It has done that by not crowding out the private sector and civil society, by delivering with some effectiveness key services, such as macroeconomic management, human

¹⁵⁷ See Sen, B. (2004).

development and disaster prevention, and providing a certain degree of continuity in government policies despite changes in government. These positive governance aspects arise from recognition by the state of its weak implementation capacity and stepping back from its role as a producer to that of regulator and facilitator. While the stepping back has contributed to a strong private sector response and has been crucial in the delivery of essential services where NGOs and the private sector have stepped in, the government's capacity to regulate and facilitate is uneven and governance issues have been a serious impediment to delivering on these new roles.

7.20 *However, these positive governance aspects are somewhat overwhelmed by the significant weaknesses in a number of other governance areas.* The weaknesses lie principally in the country's core governance systems: its politics, the way it funds elections, the way it manages its public finances including revenues and expenditures, the way it delivers public services and the legal and judicial services it provides its citizens, all of which have a profound impact on development and economic growth. There are serious sectoral governance challenges as well which have an adverse impact on growth. These are discussed in **Chapters 8** for the financial sector and in **Chapter 9** for the infrastructure sector.

V. Challenges in Core Governance

7.21 *The most serious and difficult governance challenge lies in the political domain where confrontational politics and the high cost of election finance have severe adverse economic consequences.* Governance challenges also severely impede public financial management. There are major shortcomings in tax administration (poor taxpayer services, lack of transparency in collection, inadequate audit and enforcement, and protracted taxpayer disputes) and the resulting low revenue collection creates a chain of disincentives to good governance, from low salaries to civil servants to inadequate operations and maintenance expenditures and lack of effective checks and balances. Financial accountability is weak, with flawed procurement processes, poor financial controls and inadequate external checks and audits. Essential infrastructure is not properly maintained for lack of resources and leakage, while the state has little or no capacity to finance infrastructure investments. This in turn leads to a reliance on private provision of infrastructure, which is poorly managed and regulated by the state resulting in a serious infrastructure crisis. Bangladeshis in general view the civil service as being of low quality, which further feeds the vicious cycle of poor governance. Finally, the justice sector has also been a source of weakness. Although the Supreme Court and the senior judiciary are exceptions to this rule, the poor state of the lower judiciary, the police and the prosecution services means that the citizen's first encounter with the justice sector tends to be a disappointing one. Above all, the courts have difficulty enforcing contracts and enforcing the rule of law, two essentials to creating an enabling environment for the private sector. These issues are discussed in more detail below.

Political competition

7.22 *Political power has been concentrated in two major parties – the Awami League and the Bangladesh Nationalist Party – that have dominated Bangladesh's politics since independence. A first-past-the-post system of elections results in large stable majorities for governments.* A constitutional amendment that forbids members of political parties from voting against their parties in Parliament reduces the importance of Parliament as a check on the executive. The lack of inner party democracy prevents these parties from being held accountable by their grassroots. The strong centralization of the state in Bangladesh precludes the sharing of effective political power through local governments.

7.23 *The outcome is a system in which the winner takes all in elections and the loser has difficulty reconciling to the loss.* Bitter relations between the two parties lead to frequent confrontations, which often shift to the streets. Frequent *hartals*, or work stoppages, are one consequence, which according to a

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UNDP report costs the economy some 3-4 per cent of GDP annually. The dependence of political parties on muscle power results in the criminalization of politics and increasing political violence. Fundamentalist groups which appear to have a rather modest public following have nevertheless exploited this dissension among the secular parties in recent years to pursue their own agenda.

7.24 *Bangladesh is not unique in its confrontational politics; developed and developing nations have shown this tendency. But the fractiousness contributes to political uncertainty and to perceptions of political instability for outside investors who may not always understand that much of this tends to be “sound and fury,” signifying little.* Potential foreign investors taking a long-term view of investments in developing countries tend to stay away from what they see as a high risk environment which has a significant impact on growth. The answer lies in a number of political reforms that improve the quality of political competition in Bangladesh, including strengthening the role of Parliament and parliamentary committees including ensuring an effective role for the opposition in the work of parliament, decentralization of power to local governments, requiring inner party democracy for political parties contesting elections and strengthening civil society watch dogs of the political process. These changes can only come if the people of Bangladesh demand it and cannot be imposed from outside.

The high cost of elections

7.25 Elections in Bangladesh, like in many democracies, tend to be a costly affair, and certainly cost much more than the Tk 500,000 that election rules permit for each parliamentary candidate. *Parties and individuals wanting to get elected must raise funds to fight elections and this opens the door to undue influence of money on public policy.* Moreover, because actual expenditures on elections exceed prescribed limits they result in a lack of transparency about the source of such funds and blur the line between a parliamentarian's public and private use of such funds. State capture resulting from the incurring of debt to vested interests distorts trade and industrial policies and erodes competition. Public funding of elections, reducing the cost of fighting elections through limited free access to TV and radio for candidates, and requiring transparency relating to donations for elections will help. Enforcing existing laws requiring candidates to declare their assets and liabilities will be critical.

Low revenue mobilization

7.26 *Bangladesh's revenue effort has been weak, and for the past several years it has stagnated.* With a population of 140 million, the country has only 1.4 million registered tax payers and 300 businesses registered for its value added tax. Total tax revenue is a low 8.5 percent of GDP. This reflects the low elasticity of revenues with respect to income growth due to a heavy dependence on import taxes (45 percent of total tax collections) and numerous exemptions, tax holidays and preferences. It also reflects a tax administration that is weak and open to corruption. Investment climate surveys show that half the firms see tax administration as a major or severe obstacle to investment, almost double the average for all countries surveyed, and 42 percent of firms see customs administration in the same way, more than double the average for all countries surveyed. It takes as much as 11 days for imports to clear customs, nearly twice as long as the average country surveyed. While customs has seen some improvement of late, shippers still face cumbersome processes including large number of approval processes (15 signatures for exports on average and 38 for imports) and many opportunities for face to face contacts with customs and tax inspectors and staff which create opportunities for rent seeking. Tax administration is complicated by a cumbersome management system that lacks clear direction and leadership and an organizational structure based on type of tax which tends to duplicate functions (such as audits and collection) and undermine the exchange of information. This forces taxpayers to deal with different units on similar issues, with little scope for redress.

7.27 *Apart from the direct disincentive effects for potential investors, governance issues in tax and customs administration raise the cost of doing business in Bangladesh and erode the country's competitiveness.* They also reduce the resources available to the state to pay adequate salaries to civil servants, meet operations and maintenance (O&M) expenditures, and finance much needed infrastructure for growth. Low provisions for salaries and wages and O&M feed the vicious cycle of corruption which constitutes an across the board tax on growth.

7.28 *The National Board of Revenue (NBR) is embarking on a reform program to address these issues.* The government has established Large Taxpayer Units for Income Tax and VAT to help improve tax collection and reduce the costs of dealing with the NBR. A strategic development plan has been recently approved aimed at raising revenue collections, organizing the NBR along functional lines, and ensuring that all businesses are treated uniformly and equitably.

7.29 *A comprehensive tax administration modernization program is being developed by GoB.* The modernization program will include developing new functional areas such as tax payer services, audit functions to detect underreported income and collection enforcement. These new functions will be piloted by the Large Taxpayer Units for income tax and VAT, and will be supported by reengineering processes and automation. The NBR's composition will be strengthened and based on functional lines. Human resource policies and procedures will also be improved to ensure more professional and competitive recruitment and promotion policies, training, compensation and career development. The NBR will also be encouraged to work with exporter and taxpayer associations to ensure that the quality of service improves and to make the NBR more client-friendly. Periodic surveyors of taxpayers, exporters and the general public will monitor perceptions of the NBR's progress in addressing the concerns of its clients.

Public financial accountability

7.30 *A recent World Bank review of institutional arrangements for public expenditure, financial management and procurement revealed the need to significantly strengthen Bangladesh's public financial management.* Key links in the chain of public financial accountability are flawed:

- *A serious weakness is the lack of a strategic planning process reflected in the routine over-programming of the annual development plan.* This results in the reliance on discretion rather than rules, creates opportunities for rent-seeking and leads to too many under funded projects, implementation delays and chronic under expenditure. Budget planning is fragmented between recurrent and investment budgets and preoccupied with inputs rather than outputs and outcomes, resulting in weak performance orientation. All these contribute to weakening the impact of public investment on growth and development.
- *Weaknesses in budget execution related to poor accounting practices,* including reliance on manual systems which weaken accountability and transparency, and reporting delays. All these contribute to leakages reducing the effectiveness of budgetary spending. State-owned enterprises do not use international accounting standards. This contributes inter alia to a lack of transparency about contingent liabilities in the budget.
- *Weak internal and external controls* is reflected in the lack of accounting information and proper financial controls in line ministries, delays in the publication of audited reports, unsatisfactory quality of the external audit function and ineffective parliamentary oversight over the entire budget process. A new Anti-Corruption Commission has so far not been able to make an impact as an additional weapon in the government's armory against corruption.

7.31 ***The Government has begun to address some of these weaknesses. It has strengthened strategic budget planning by expanding the medium-term budget framework (MTBF) approach.*** The MTBF approach has been introduced on a pilot basis in ten ministries (6 in FY06 and 4 in FY07), and there are plans to cover another four ministries in the FY08 budget. This will bring MTBF coverage to more than 65 percent of total budgetary expenditure. The emphasis at this initial stage has been on better integration of the revenue (recurrent) and development (investment) budget planning processes at the center and line ministries, by unifying the budget preparation process and issuing an integrated budget ceiling for line ministries. The MTBF approach has also given more flexibility to the line ministries in their spending allocation decisions, and has encouraged the substantive involvement of senior officials in the budget formulation process, which otherwise was considered routine work and typically undertaken by lower-level officials. Despite such progress, the process is still in its infancy, and needs to be significantly deepened before it can produce tangible gains in linking policies and budgets and contribute to better budget and service delivery outcomes.

7.32 ***To strengthen budget execution, serious efforts are being made to improve the accuracy and timeliness of expenditure and strengthen internal and external accountability, audit and scrutiny.*** A customized computerized accounting system has been rolled out 60 district accounts offices and 49 chief accounting offices. In early FY07, the Ministry of Finance and Planning issued a circular notifying the Government's decision to adopt the International Public Sector Accounting Standards (IPSAS) cash standards for accounting. Several government agencies have started implementing this circular. The Government has also reduced a major conflict of interest by separating out the internal and external audit functions. To strengthen the internal audit function, the Government has prepared a Public Expenditure Management Manual and the Internal Control Manual, and taken steps consistent with the manuals, including separation of cash management from debt management. The time lag for final audited accounts has been reduced from two to one year. The Comptroller and Auditor General (C&AG) has introduced performance and entity based audits on a pilot basis and is planning to roll them out across various government units. Audit committees are being formed in ministries, and the Government remains committed to making the C&AG functionally and administratively independent

7.33 ***Reform efforts have also sought to strengthen the transparency of fiscal information and key institutions of accountability in public financial management.*** To this end, GoB developed baseline ratings of the core PFM functions in early 2006 and more recently prepared a comprehensive, medium-term, rolling Public Financial Management Improvement Plan (PFMIP) that lays out a series of second-generation PFM reforms. Among the initial implementation measures, the FY07 Budget Summary, for the first time, included an explanatory note that listed all explicit and counter guarantees provided by the Government against liabilities of SOEs; these amounted to US\$2.5 billion (4 percent of GDP). Furthermore, in FY07, GoB began setting up a technical support unit for the Public Accounts Committee (PAC) in the Legislature and developing a system of information that would increase the transparency of its decision-making, once the elected Parliament returns. The PAC had made good progress in reducing the backlog of audited accounts for discussion, and its deliberations were beginning to be followed by the press in Dhaka, until the Parliament was dissolved in October 2006.

Transparency and competitiveness of public procurement

7.34 ***A key element in strengthening public financial management is making public procurement much more competitive and transparent.*** Bangladesh, like many developing countries faces significant challenges in improving its public procurement, which typically has been subject to considerable delays, lacks transparency and is open to collusive practices. It is widely regarded as being the single most important source of leakage of public funds in Bangladesh. Reducing opportunities for corruption in procurement will significantly enhance the effectiveness of public expenditures, reduce the costs of public infrastructure and donor financed projects and contributes to faster growth. Recognizing this, the

Government has initiated a number of reforms in the area. Despite strong resistance from powerful vested interests, the previous Parliament adopted a new law on public procurement in July 2006, with many provisions that are in line with well-accepted international practices. The Government is now finalizing the rules to implement the law, and in the interim is using the regulations that were the precursor for the law. The regulations have introduced new standard bidding documents that significantly reduce the layers in the procurement approval processes. The Government has also put into place a unique procurement performance tracking and monitoring system and is piloted it in a few agencies.

7.35 Moving ahead, strong compliance monitoring, not just by the Central Procurement Technical Unit, which manages the Government's procurement process, but also by civil society and NGOs through procurement watch activities will be crucial to effective implementation. Systematic outreach to potential bidders in the business community, including civil works contractors, consultants and suppliers, will be necessary to explain the new law and seek their cooperation in making it a success.

Quality of the civil service

7.36 ***At the root of the failure of the state to contribute effectively to growth, as in many countries, is a civil service that is politicized, poorly paid and poorly managed.*** Bangladesh's civil service today is inadequately trained, hierarchical and secretive and subject to political influence. Lack of accountability contributes to poor service delivery, the deterioration in regulatory quality and many of the problems discussed above in public financial management and revenue mobilization.

7.37 ***Numerous commissions and reviews have addressed these concerns, and the Government has acted on some of the recommendations.*** The size of the public service and the wage bill has been successfully contained. A career planning wing of the Ministry of Establishment was created to focus on career planning and effective deployment of Class I officers. A training policy has been announced and training is now a criterion for promotion of officers. Key to further reform will be strengthening the personnel management system, ensuring a merit and performance based system of promotions toward which initial steps have been taken, a strategic use of postings and transfers to strengthen capacity and match available skills to requirements, a revised compensation package, particularly for the senior cadres of the civil service who are relatively poorly paid for their level of responsibilities.

The rule of law

7.38 ***The rule of law is central to the growth process.*** While Bangladesh's Constitution has provided for all the formal requirements of a society based on the rule of law, in practice the system fails to deliver, as is evident from the low confidence in the judicial system cited above. With the possible exception of the Supreme Court, all the key pillars of the justice sector are weak, inefficient and prone to corruption. Law and order is perceived to be weak. The police are held in little confidence. In part this is a matter of staffing: its 80,000 complement makes the force quite the smallest in the sub-continent in relation to population. In part it reflects the emphasis placed on maintaining a modicum of public order and protecting the wealthy rather than preventing, detecting and investigating crime. A weak prosecution service and an inefficient and allegedly corrupt lower court system contribute to the lack of justice.

7.39 ***For ordinary citizens, access to justice is impeded by the high costs of the system and the low probability of a successful resolution.*** For businesses, the inability to enforce contracts promptly and to secure property rights, particularly for land, greatly raises the cost of doing business in Bangladesh. Creditor and minority shareholder rights are well protected under the law, but enforcing these rights is another matter. But as is noted in **Chapter 8** on the financial sector, lenders and borrowers must deal with a flawed collateral system. Unreliable land records, high fees and fraud hamper land titling. And as noted below, registering a property is cumbersome, and enforcing a contract through the courts is costly.

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Bankruptcies are not an easy solution to corporate distress. It takes 4 years on average to shut a business down, and you may recover 24 cents on the dollar, better than the regional average of 20 cents, but much lower than the 44 cents that are recovered in Pakistan and Thailand or even the 40 cents recovered in Uganda. While domestic entrepreneurs learn how to survive the system and absorb its high costs, foreign investors unfamiliar with Bangladesh and with plenty of other places to invest in are greatly deterred by these failures.

7.40 *Comprehensive but well sequenced reforms of the justice sector are long overdue.* The Government has begun modestly with a program to strengthen court administration and reducing delays through an automated case management information system, strengthened judicial training, upgrading facilities and other human resource needs in five pilot districts and the Supreme Court. Important steps have also been taken to separate the judiciary from the executive. DFID, Japan and UNDP are helping with police reforms. But more comprehensive reforms will be crucial if the failure to ensure the rule of law and protect property rights is not to prove a serious impediment to the acceleration in growth that is the topic of this report.

Improving the regulatory environment

7.41 *The formal hoops that new businesses must jump in Bangladesh may be relatively modest (Table 7.2), but the red tape is more formidable in practice than it is on paper.* The high informal regulatory costs are especially worrying in the post-ATC environment where garments exporters must compete with low cost producers in China, India, and Vietnam. Adding even a few cents to the price of a garment can cause business to go elsewhere given the competitiveness of markets. The Government recognizes this and is working to streamline the regulatory process and strengthen its regulatory policy capacity. Industrial zoning programs are being considered to insulate investors from some of the constraints they face operating in Bangladesh. The Board of Investment, the Bangladesh Export Processing Zones Authority, the Registrar of Joint Stock Companies and other regulatory institutions are strengthening their capacity to support investors and simplifying their procedures.

VI. Conclusion

7.42 Bangladesh has enjoyed good growth since the early 1990s despite weak governance. Growth has accelerated slightly in recent years, but as is argued elsewhere in this report, diversification of the economy and improving the environment for foreign direct investment will be central to bringing Bangladesh's performance closer to its neighbors in the region. Like Indonesia and other South East Asian countries in the early 1990s, Bangladesh is likely to soon discover that it is fast growing out of its current institutional environment. While governance may have been adequate to cope with an economy breaking out of stagnation and poverty, it is increasingly proving a barrier to the acceleration of growth that is needed to push Bangladesh firmly on the path of middle income status and poverty reduction. And yet, from a political economy perspective, the fact that growth has been adequate and rising reduces the pressure on political leaders to address the governance issue.

7.43 Addressing the governance challenge will also not be easy. 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. Summoning the political will to do this will not be easy, and will itself depend on strong political leadership and a public that demands reforms and shows lower tolerance for weak governance.