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Explaining South Asia's Development Success

The Role of Good Policies



THE WORLD BANK

Sadiq Ahmed

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Foreword

Not long ago, South Asia was mostly known internationally as a region of simmering internal and external conflicts that was home to the world's largest number of poor people and was characterized by low per capita incomes, poor social indicators, and weak economic prospects. Today, the picture has changed dramatically. Between 1980 and 2005, per capita income in nominal dollars nearly tripled, poverty almost halved, and human development indicators improved noticeably. South Asia is now second only to the East Asian and Pacific economies in its rate of growth, and the gap is closing. While India has led the way in this heady economic performance, the other large South Asian countries, Bangladesh and Pakistan, are also moving forward.

The transformation of the South Asian economies is now drawing international attention. Remarkably, this progress has occurred despite many constraints, including weak governance and political and social conflicts. What factors have contributed to this development

success? Drawing on a vast body of data and on sound analysis, Sadiq Ahmed examines this question, arguing that South Asia's development outcomes are the result of good policies. Whereas the pace and pattern of policy reforms have varied by country, some common threads are apparent. Across the region, the main focus of policy reforms has been to unleash the power of the private sector by providing a prudent macroeconomic framework, by deregulating the economy, and by supporting integration with the global economy. Higher levels of private investment and productivity have fueled economic growth, which rose from an average of around 4 percent per year during 1960–80 to 6 percent per year during 1980–2005. Rapid growth, along with public spending on human development, contributed to reducing poverty and improving human development.

Notwithstanding this progress, this book rightly notes that South Asia's challenge for the future remains substantial and even faster growth will be needed to make more rapid progress in poverty reduction. At the same time, the region needs to address the growing income inequalities at the individual level as well as between areas within countries. The quality of human development also needs to be substantially improved. These issues will require deepening reforms and addressing the many governance and institutional challenges.

This book is an important contribution to understanding development in South Asia. Sadiq Ahmed brings clarity to many of the questions we ask about how nations develop and why, what works, and what holds a country back. Students of development, members of the donor community, and policy makers in South Asia and elsewhere will find this an excellent reference and a thought-provoking read about the development challenges in this important region.

Praful C. Patel

*Vice President, South Asia Region
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Acknowledgments

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About the Author

Sadiq Ahmed is Sector Director for Poverty Reduction and Economic Management in the South Asia Region of the World Bank. He previously served as country economist for Egypt and Indonesia, Country Director for Pakistan and Afghanistan, and Chief Economist for the South Asia Region. He has written and published in areas of monetary policy, public finance, trade, and development. His most recent work, *Transforming Bangladesh into a Middle Income Economy*, was published by MacMillan in 2005.



1 Issues and Themes

Between 1980 and 2003, South Asia's per capita gross domestic product (GDP) grew by 3.4 percent per year, compared with zero growth in Sub-Saharan Africa and 2.4 percent annual growth in all low-income economies. During the same period, average life expectancy increased by 10 years in South Asia, reaching 63 years in 2003, compared with 58 years for all low-income economies. The incidence of poverty declined from 52 percent of South Asia's population subsisting on less than US\$1 per day in 1980 to 32 percent in 2001. Significantly, per capita growth grew more rapidly at the beginning of the 21st century than at the end of the 20th century, reaching 4.5 percent per year during 2000–3. If the region's policies and external environment remain unchanged, expectations are that South Asia will continue to grow at around 4 or 5 percent per year in per capita terms over the medium term. These growth rates are expected to further reduce the incidence of poverty.

This development performance, although below that in the countries of East Asia and the Pacific and believed to be lower than South Asia's potential, is still a commendable achievement. It has given hope to the millions of poor in the region that achievement of the Millennium Development Goals is an attainable target. Indeed, many analysts believe that South Asia can grow even faster than in the past, thereby providing the basis for more rapid and sustained poverty reduction and further human development progress.

POLICIES OR PUZZLE?

What factors have contributed to these good development outcomes? What are the prospects for South Asia to sustain and improve on its past performance? These are important questions and debate about them is ongoing. At the heart of this debate is the role of policies, especially the types of policies that Williamson (1990) has summarized under the rubric of the "Washington consensus." The debate has been fueled by experiences in Latin America and the Caribbean, where per capita income has increased slowly, and Sub-Saharan Africa, where per capita income has been stagnant. Critics believe that on the whole, the Washington consensus has not worked in countries in these regions, putting the efficacy of the Washington consensus in doubt. Many also see South Asia's experience as a development puzzle, because good development outcomes have occurred despite weak institutions (for a recent summary of this debate with reference to South Asia, see Devarajan 2005).

Analytical foundations for analyzing growth

Before looking at South Asia's experience, a brief look at the underlying analytical framework that links growth with policies will be useful. Unhappiness with the limited usefulness of the neoclassical growth model (Solow 1956) in explaining growth in low-income economies has contributed to the emergence of major research geared toward this task (see Temple 1999 for a summary of the evidence and issues). Related to this revival of interest in explaining growth is the debate on the role of policies. One school of thought does not see much of a relationship between growth and policies (Easterly 2004). Another

considers that while some policies may be relevant depending upon country circumstances, the policy framework the Bretton Woods institutions have traditionally relied upon, that is, the Washington consensus, is not particularly helpful in explaining growth (World Bank 2004c). In both these approaches, what matters most for growth is the development of institutions: “Good institutions matter more for growth than good policies—that institutions rule” (World Bank 2004b, p. 3). A third school of thought is the so-called binding constraint approach, which argues that the laundry-list approach of the Washington consensus should be discarded in favor of a new framework that seeks to identify the binding constraints to growth and that policies should be targeted toward alleviating these constraints (Hausmann, Rodrick, and Velasco 2004). Most recently, in a presentation to World Bank staff, Spence (2005) outlined an approach to understanding growth based on considerations private enterprises use in making investment decisions, which is referred to in this book as the micro foundations of growth.

Spence’s micro foundations approach provides a way to explain growth that is conveniently linked to the debate about the role of policies. This approach starts with the premise that growth concerns increases in per capita incomes. In a market economy, such growth reflects average productivity levels. Productivity levels in turn depend upon a range of assets that is accumulated over time. These assets, which are considered to be necessary for growth to occur, can be both tangible and intangible and reflect accumulated private and public investments. The impact of these assets on average productivity is influenced by technical progress. The assets that determine productivity levels include private tangible capital (plant and equipment); infrastructure (transport, energy, and communications); facilities and real estate (both public and private); human capital (health and education); scientific and technical knowledge; macroeconomic stability; and a functioning legal and regulatory environment. Growth results primarily from balanced accumulation of these assets.¹ This balance is needed because the assets complement each other. Thus the return to investment in any category rises with the levels of other assets. As a corollary, to maximize growth, public and private investment should go to categories with the highest marginal impact.

Role of policies in explaining growth

In this framework, policies have a number of roles. First, policies that affect levels of domestic saving and investment, for example, those that affect the investment climate and macroeconomic policies, will have a major impact on growth. Second, policies that guide investment to the right assets, for instance, policies that influence the composition of public spending in favor of infrastructure and human development and those that promote private investment in these areas, will affect growth. Third, policies that influence foreign investment, such as those that eliminate barriers to foreign investment and improve the domestic investment climate, can augment growth by relaxing constraints to domestic saving and investment. Fourth, globalization, that is, trade and investment openness, can contribute to growth by expanding markets (demand), supplying capital in excess of what is available domestically, and enabling the transfer of technology. Fifth, policies that help establish institutions, such as a functioning legal and regulatory environment and knowledge institutions, are necessary to support growth.

What is the relevance of this framework for the Washington consensus? This term has been much abused. Williamson (1990) coined it to describe the 10 policy reforms for which consensus among the technocratic Washington of the international financial institutions, the economic agencies of the U.S. government, the Federal Reserve Board, and the think tanks appeared to be broad. These reforms are

- maintaining fiscal discipline as measured by low fiscal deficits
- setting public expenditure priorities that favor health and education expenditures rather than defense spending, general public administration, and subsidies
- undertaking tax reforms to increase revenues using a broadly based tax system with low marginal rates
- having interest rates that are market based and are positive in real terms
- maintaining a competitive exchange rate to promote exports
- basing trade policy on import liberalization with moderate tariffs (10 to 20 percent with little dispersion)
- encouraging foreign direct investment
- supporting privatization

- promoting competition through deregulation
- defining and ensuring property rights.

The Washington consensus is thus entirely consistent with Spence's approach. Indeed, both approaches are part of a broad pattern of greater reliance on the market to support economic growth. Fiscal discipline, tax reforms, and interest rate and exchange rate management are all key elements of macroeconomic stability. Trade liberalization, economic deregulation, privatization, property rights, and foreign direct investment are important determinants of the investment climate for private investment. Public expenditure priorities are important for creating infrastructure and human capital assets, both of which are necessary for growth. Where the Washington consensus in its original formulation differs from Spence's approach is that it does not emphasize the role of institutions sufficiently, such as a functioning regulatory and legal framework and the role of knowledge institutions. Indeed, in a recent speech at the World Bank, Stern (2005) commented that while ridiculing the Washington consensus was currently fashionable, a careful look at what it means will reveal that it was not at all bad in terms of what it stood for, but that it did not go far enough in emphasizing the role of institutions. Its other limitation is that proponents have tended to use it as a prescription for all countries and for all times without looking at the specific country context.

How does one reconcile the Spence approach to explaining growth with the two other approaches noted earlier? Regarding the issue of policies versus institutions, the distinction is overdrawn. Both are needed for growth, as emphasized by the Spence approach. Because institutions are politically more contentious and take longer to establish even when there is agreement, a feasible possibility is that good policies can be implemented more rapidly and easily than institutions. Indeed, this seems to have been the case in the South Asian countries. Regarding the binding constraint hypothesis, its main contribution is its emphasis on the need to set priorities given low-income economies' limited capacity to implement reforms.

Identifying binding constraints and focusing on reforms sequentially, starting with the highest priority reform, is logical, but the main difficulty is how to apply this in practice. The shadow price approach to identifying binding constraints has many problems, including lack of

adequate knowledge of the structure of the economy, weak information and databases that could convey misleading results, and inability to capture the complementarities of reforms. As Spence (2005) forcefully argues: “The search for necessary and sufficient conditions is elusive; we can look for necessary conditions.” As full knowledge of the necessary and sufficient conditions for growth in any specific country context is unlikely unless one starts with a list of all necessary conditions and checks whether or not these have been met, some necessary conditions might be missed. A related problem is the political economy. Identifying constraints at the technical level is not enough. In many instances, binding constraints may have to do with the political environment. Feasible reforms will emerge from what this political environment will allow.²

Summary of the relationship between growth and policies

To summarize this discussion, sound economic policies and institutions can both influence growth outcomes, as emphasized in the Spence approach. The reforms contained in the Washington consensus constitute a sensible list of policies that can influence growth, as noted in the Spence approach, provided these are tailored to the specific needs of the country concerned and sequenced with progress in establishing appropriate institutions. Given the limited capacities of low-income economies to implement reforms, priorities will need to be set. While good diagnostic analysis of what constrains growth will be helpful, in practice, the priorities will emerge from the political environment for reforms.

MAIN MESSAGES

The objective of this monograph is to look at experience in the South Asian countries and provide some insights to the debate. The starting hypothesis is that South Asian countries' good development performance since the 1980s is the outcome of sound policies—many of which are consistent with those included in the Washington consensus and emphasized in the Spence approach—that have supported growth, improved human development, and helped reduce poverty. Thus the South Asian countries' good development progress despite weak institutions is not as much of a “puzzle” as some might think, because the

effects of the large number of good policies have prevailed despite overall weak institutions.

The monograph argues that these policies need to be maintained and deepened along with more progress in building institutions in order to accelerate growth further to secure a faster pace of poverty reduction. Related to this, it notes the evidence of growing income inequality and argues that this reflects policy failures in a number of areas that need to be addressed to make growth work better for poverty reduction. The experience in South Asia may not be generalizable to other regions, but at the same time, policies that seem to have worked in South Asia should not be hastily discarded.



2 Development Performance in South Asia

A Comparative Analysis

This chapter looks at South Asia's development performance in terms of three indicators: GDP growth, poverty reduction, and human development. It puts South Asia's performance in an international perspective, thereby providing a measure of relative progress and an indication of the magnitude of the future challenge.

GROWTH PERFORMANCE

Between 1960 and 2003, per capita GDP in South Asia grew by 2.4 percent per year, compared with 4.7 percent in East Asia and the Pacific, 0.5 percent in Sub-Saharan Africa, and 1.7 percent in low-income economies. Table 2.1 breaks down this growth by decade.

A number of interesting observations emerge from this review of growth. First, growth in South Asia was modest during the 1960s and the 1970s. This was largely due to slow growth in India, the largest

Table 2.1 **Comparative Per Capita GDP Growth Performance, Selected Regions, 1960–2003***(percent per year in 1995 dollars)*

Region	1960–70	1970–80	1980–90	1990–2000	2000–3	1990–2003	1960–2003
East Asia and the Pacific	2.4	4.6	5.6	6.4	5.8	6.2	4.7
South Asia	1.9	0.6	3.3	3.0	4.5	3.4	2.4
Sub-Saharan Africa	2.6	0.7	−1.2	−0.4	1.0	0.0	0.5
LDCs	1.7	0.6	0.6	1.9	3.3	2.4	1.7

Source: World Bank central database.

Note: For a definition of countries included in regional groupings, see World Bank (2005e). In particular, China is included in East Asia and the Pacific. Regional average growth rates are based on income weights.

Table 2.2 **Per Capita Growth, South Asian Countries, 1960–2003***(percent per year in 1995 dollars)*

Country	1960–70	1970–80	1980–90	1990–2000	2000–3	1990–2003	1960–2003
Bangladesh	—	2.3 ^a	1.1	3.0	3.2	3.1	2.0 ^b
India	1.7	0.7	3.6	3.6	4.3	3.8	2.5
Nepal	0.6	0.0	2.4	2.6	0.3	2.5	1.3
Pakistan	4.2	1.5	3.5	1.4	1.3	1.4	2.5
Sri Lanka	2.1	2.6	3.1	3.9	1.3	3.3	2.8

Source: World Bank central database.

— = Not available.

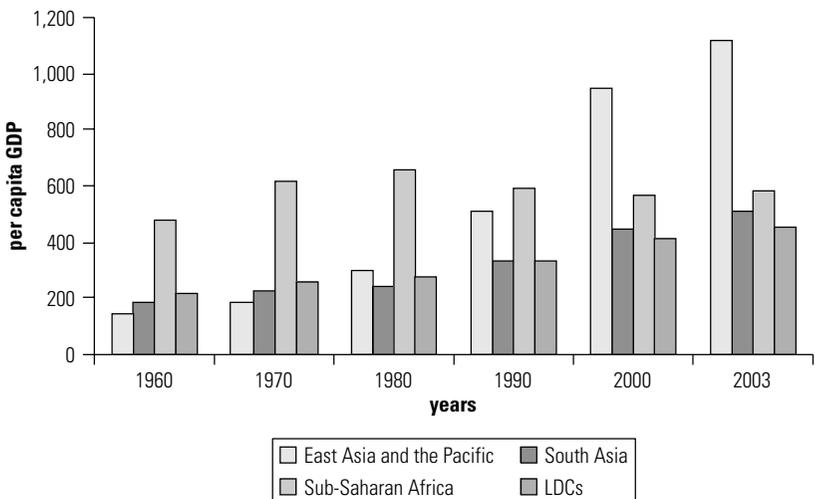
a. Refers to 1972–80.

b. Refers to 1972–2003.

country in South Asia (table 2.2). Growth in South Asia started climbing in the 1980s, with further acceleration in 2000–3. Not surprisingly, India led the way in this growth acceleration. Second, within South Asia, while India dominated the region's growth outcome because of its size (80 percent of South Asia's population and 80 percent of total GDP), with the exception of Nepal, per capita GDP growth was broadly based across the region when seen from a long-term perspective, and

average, long-term, per capita GDP growth ranged from 2.0 to 2.8 percent in Bangladesh, India, Pakistan, and Sri Lanka. During the 1990s, growth faltered in Pakistan, but was robust in the other countries. India grew the fastest, followed by Sri Lanka and Bangladesh. Nepal also posted good growth, continuing its modest recovery from the 1980s. Growth in Pakistan has recovered in recent years. Third, while Sub-Saharan Africa grew more rapidly than either East Asia and the Pacific or South Asia in the 1960s, it suffered a long period of decline and stagnation during 1980–2000, though some signs of a halt to this slide along with a small increase in per capita growth were apparent in 2000–3. Overall, per capita GDP in Sub-Saharan Africa grew a mere 0.5 percent per year during 1960–2003. Fourth, East Asia and the Pacific has been the growth leader, with growth accelerating from 2.4 percent per year in the 1960s to 6.4 percent in the 1990s. Like South Asia, growth was fairly broadly based in East Asia and the Pacific, even though China has led the way since the 1980s.

The implication of these per capita growth rates for income levels has been dramatic (figure 2.1). Between 1960 and 2003, per capita income in constant 1995 dollars increased by 648 percent in East Asia and the Pacific, by 176 percent in South Asia, by 110 percent in all



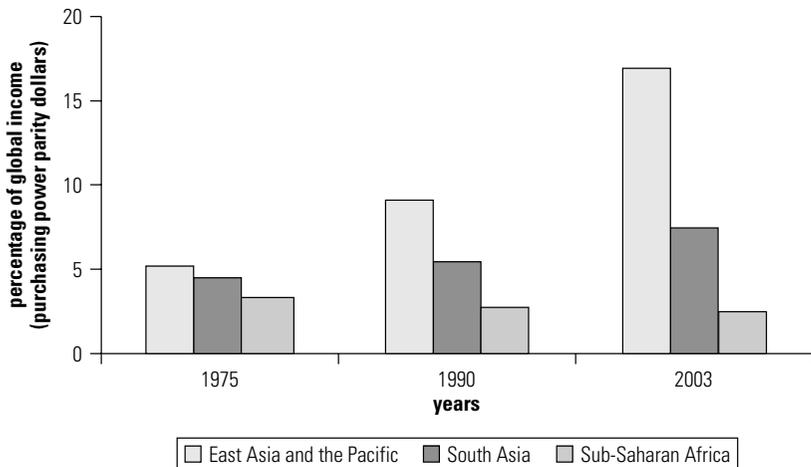
Source: World Bank central database.

Figure 2.1 Comparative Per Capita GDP, Selected Regions and Years (1995 US\$)

low-income economies, but by a mere 23 percent in Sub-Saharan Africa. In 1990–2003, per capita GDP expanded by 120 percent in East Asia and the Pacific and 54 percent in South Asia, but stagnated in Sub-Saharan Africa, with zero expansion.

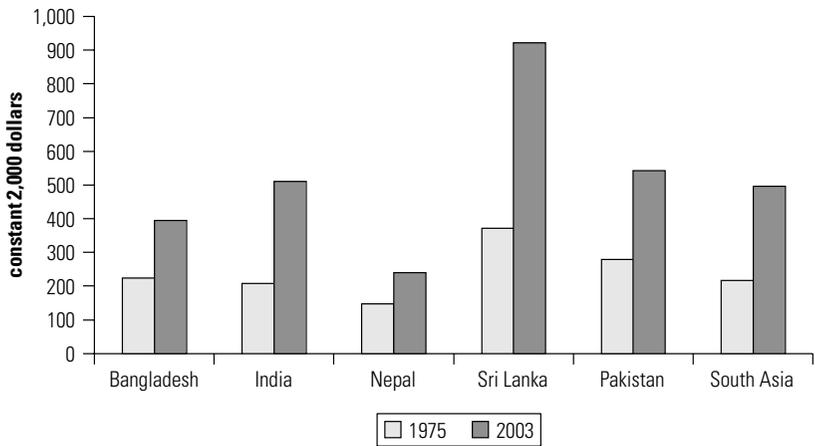
These developments also had important global implications, which are best seen by looking at regional income levels measured in purchasing power parity terms. The first year for which comparative data are available is 1975. Figure 2.2 shows the distribution of incomes in selected regions measured in purchasing power parity terms. In 1975, South Asia accounted for 4.5 percent of world incomes. This figure grew to 5.6 percent in 1990 and increased further to 7.4 percent in 2003. Not surprisingly, the share of East Asia and the Pacific rose much faster. The share of Sub-Saharan Africa actually shrank from its already low level, declining from 3.3 percent in 1975 to 2.5 percent in 2003. South Asia's rising share of global income is indicative of the progress the region is making relative to the rest of the world. The much faster increase in East Asia and the Pacific is indicative of the challenge facing South Asia.

Within South Asia, differences in per capita income expansion appear less striking than experience in other regions would suggest. This is because all the major countries in the region, including Nepal,



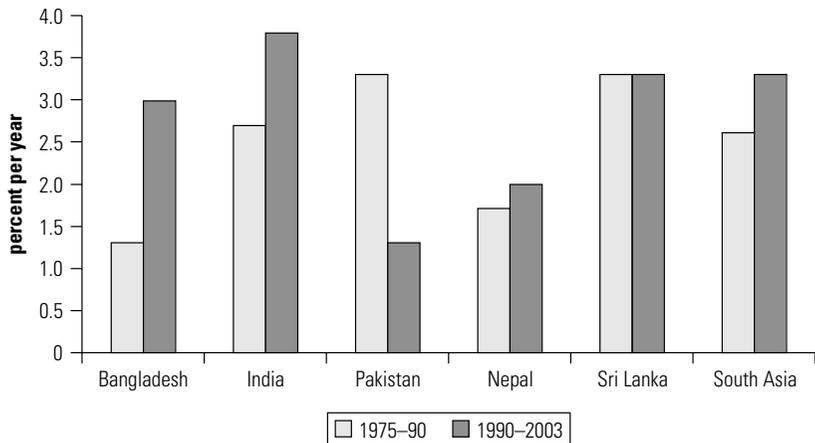
Source: World Bank central database.

Figure 2.2 Progress with Income Expansion, Selected Regions and Years



Source: World Bank central database.

Figure 2.3 Per Capita Incomes, South Asia, 1975 and 2003



Source: World Bank central database.

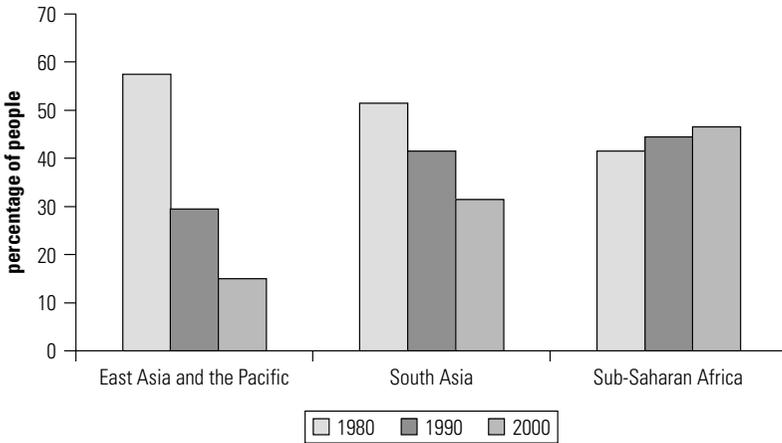
Figure 2.4 Per Capita Growth Trend, South Asia, 1975-2003

experienced positive growth in per capita incomes (figure 2.3). Nevertheless, important differences are apparent in growth experiences between countries and over time. Sri Lanka grew the fastest over the period as a whole, although India overtook it in the 1990s. India caught up from its low initial level and was the fastest-growing country in the 1990s (figure 2.4). Bangladesh and Pakistan grew more

slowly than the regional average, although Bangladesh gained momentum in the 1990s while Pakistan's growth slowed; however, Pakistan's growth momentum seemed to have been restored in 2003–5. Nepal grew significantly more slowly than the other South Asian countries, and as a result, the divergence between Nepal's per capita income and that of the other countries widened. Growth in Nepal picked up some strength in the mid-1990s, but the effort seems to have been short-lived, with growth slackening since 2003.

PROGRESS WITH POVERTY REDUCTION

Comparing poverty levels across countries and regions is fraught with measurement problems. Obtaining long-term comparative data on poverty is even more complex. To address interregional comparability problems and get an aggregative measure of global poverty, the World Bank has come up with a simple indicator: the percentage of people living on less than a dollar a day (Chen and Ravallion 2000).³ The poverty measurements based on this indicator are now available for 1981–2001. The results are shown in figure 2.5.



Source: Ravallion and Chen 2004.

Figure 2.5 Percentage of People Living on Less Than US\$1 a Day, Selected Regions and Years

The results are striking. First, East Asia and the Pacific shows the fastest decline in poverty over 1981–2001. During that period, the number of people living on less than a dollar a day fell from 58 percent to 15 percent. Second, South Asia also showed substantial progress with poverty reduction, with the number of people living on less than a dollar a day falling from 52 percent in 1981 to 31 percent in 2001. Finally, the percentage of the population living on less than a dollar a day actually increased in Sub-Saharan Africa, rising from 42 percent in 1981 to 47 percent in 2001.

Not surprisingly, the pattern of poverty broadly reflects the pattern of growth in per capita income. Much of the faster decline in poverty in East Asia and the Pacific is accounted for by the rapid growth in per capita income in the region (for econometric evidence on the relationship between growth and poverty, see Dollar and Kraay 2000). Growth and poverty reduction are similarly positively correlated in South Asia. Meanwhile, the increase in poverty in Sub-Saharan Africa is primarily a reflection of the region's growth stagnation.⁴

Looking at individual South Asian countries' experiences with poverty reduction, important variations become apparent. Even though data are not strictly comparable across countries, or in some cases even across time within countries, looking at the available evidence is nevertheless instructive (table 2.3). A number of interesting conclusions emerge. First, between 1980 and 2000, India made the most progress in reducing poverty, facilitated mainly by rapid growth in per capita incomes during this period. Both urban and rural poor benefited. Second, in Bangladesh, poverty stagnated in the 1980s, but declined during 1990–2000. This poverty pattern roughly parallels that of per capita incomes. Per capita income grew slowly in the 1980s (less than 1 percent per year), but expanded at more than 3 percent per year during 1990–2000. Third, in Pakistan, the decline in poverty in the 1980s was supported by rapid growth in per capita income, whereas the poverty stagnation during 1990–2000 is mainly a reflection of the fall in growth.

The outcomes in Nepal and Sri Lanka, however, suggest that the relationship between growth and poverty could be complicated by adverse distribution effects or other factors, such as rapid inflows of remittances that finance growth in consumption. In Sri Lanka, growth was fairly rapid in both the 1980s and the 1990s, but the overall

Table 2.3 **Headcount Measure of the Incidence of Poverty, South Asian Countries, 1980–2000***(percent)*

Country	1980s			1990s			2000		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Bangladesh ^a	50	60	58	45	61	59	37	53	50
India ^b	41	46	44	32	37	36	25	30	29
Nepal ^c	19	43	41	22	43	42	10	35	31
Pakistan ^d	38	49	46	28	37	34	24	36	33
Sri Lanka ^e	16	32	27	16	29	26	8	25	23

Source: Ahmed 2002a; World Bank 2004f, 2005c.

a. 1980s refer to 1984; 1990s refer to 1992.

b. 1980s refer to 1983; 1990s refer to 1993–4.

c. 1980s refer to 1984; 1990s refer to 1996; 2000 refers to 2003–4.

d. 1980s refer to 1985; 1990s refer to 1991.

e. 1980s refer to 1986; 2000 refers to 2002. Poverty data for 1990 and 2002 may not be comparable with data for 1986.

reduction in poverty was modest, especially in the 1980s, because of rising inequality. In addition, the effect on poverty was strikingly different in urban areas than in rural areas, with much of the gain in poverty reduction occurring in urban areas. In Nepal, while slow growth hurt poverty reduction during the 1980s and 1990s, the increase in inequality exacerbated the situation. At the same time, the surge in remittance income contributed to a large reduction in poverty during 2003–4 even as growth slowed because of the insurgency (see World Bank 2005c for a detailed review).

Ahmed (2002a) reviews the distributional implication of poverty reduction efforts in South Asia and finds evidence that the distribution of consumption as measured by the Gini coefficient worsened in all the South Asian countries between 1980 and 2000. This suggests that the full benefits of higher growth for poverty reduction were not realized. The adverse distributional implications were particularly severe in Nepal and Sri Lanka during the 1980s and 1990s, where poverty outcomes varied widely across areas. Economic growth was largely concentrated in specific locations (Kathmandu in Nepal and Colombo in Sri Lanka) and benefited poverty reduction where such

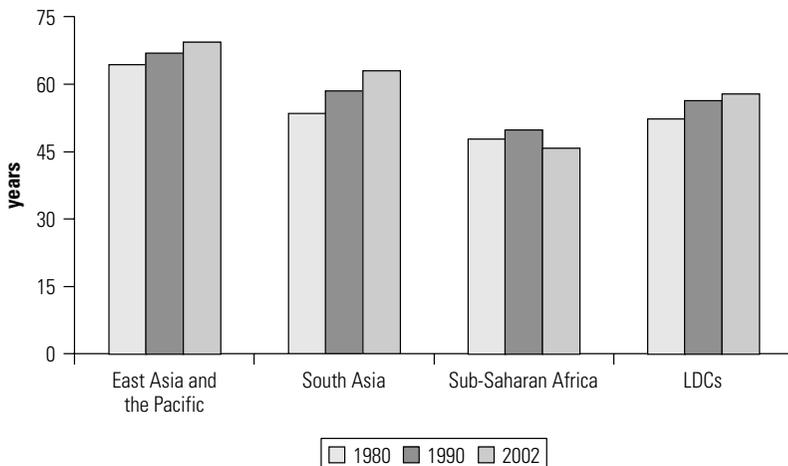
economic growth was possible, and places such as the mountainous areas of Nepal and the estates areas of Sri Lanka did not see much growth. Thus participation in economic activities was uneven. This is an important result that will be revisited later when discussing policies.

PROGRESS WITH HUMAN DEVELOPMENT

It is now well recognized that the concept of development encompasses much more than income growth. Income growth is one of the key means by which development, measured in terms of the impact on people's lives, can be achieved, but this is by no means automatic. Indeed, Sen (1999) provides examples of countries where per capita gross national product (GNP) and a number of measures of social well-being are negatively correlated. Thus along with looking at income growth and poverty, looking at indicators of social well-being is also extremely important.

Indicators affecting life and death

One fundamental measure of well-being is life expectancy at birth. Figure 2.6 shows progress in South Asia relative to that in East Asia and the Pacific, Sub-Saharan Africa, and all low-income economies.

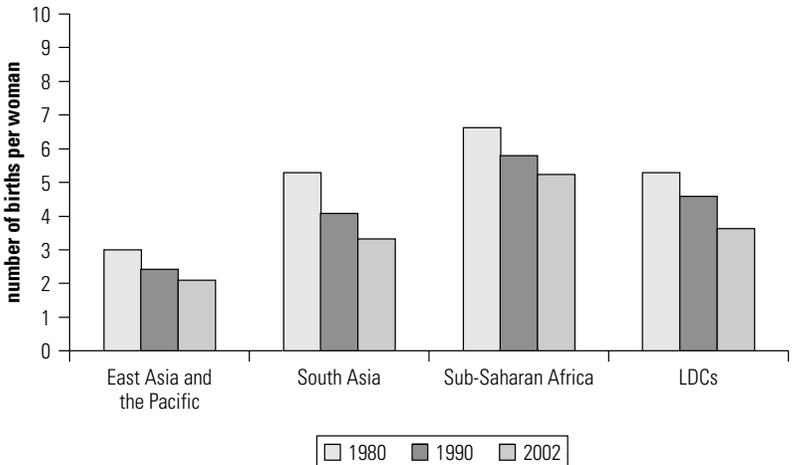


Source: World Bank central database.

Figure 2.6 Life Expectancy at Birth, Selected Regions and Years

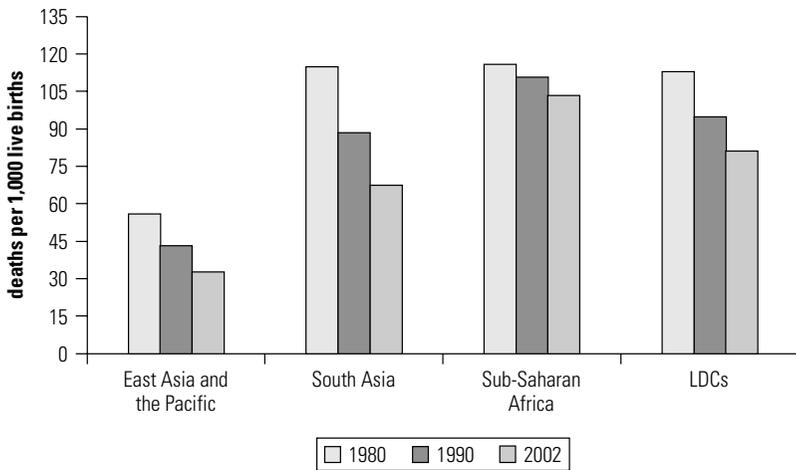
The results show a remarkable coherence with developments in relation to income growth and poverty reduction. Consistent with its leadership role in expanding incomes and reducing poverty, East Asia and the Pacific shows the highest level of average life expectancy at birth. South Asia also performs well, making more rapid progress than Sub-Saharan Africa and the average for low-income economies in improving life expectancy between 1980 and 2002. Nevertheless, South Asia still has some catching up to do to reach the levels attained in East Asia and the Pacific. The distressing result is that not only does Sub-Saharan Africa have the lowest average life expectancy, which is significantly lower than even the average for all low-income economies, but that life expectancy actually declined between 1990 and 2002. This reflects both the stagnation in per capita incomes in the past two decades and the crippling effects of life-threatening diseases such as HIV/AIDS.

Related indicators, including fertility and infant mortality rates, show a broadly similar pattern (figures 2.7 and 2.8). Many more children are born per woman in Sub-Saharan Africa, and they are more likely to die in infancy than in other regions. South Asia had a similar situation at the start of 1980s, with fertility and infant mortality rates



Source: World Bank central database.

Figure 2.7 Total Fertility Rate, Selected Regions and Years



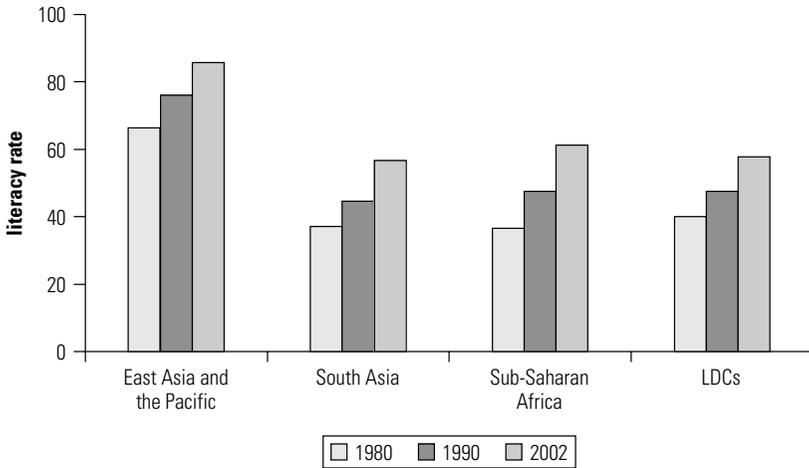
Source: World Bank central database.

Figure 2.8 Infant Mortality Rate, Selected Regions and Years

comparable to those in Sub-Saharan Africa. However, remarkably, over the past two decades, South Asia has made strong progress in reducing fertility rates and curbing infant mortality, and this progress was much faster than in other low-income economies. As a result, the gaps in fertility and infant mortality rates between East Asia and the Pacific and South Asia have decreased, and South Asia's indicators are much better than the average for all low-income economies. Sub-Saharan Africa has also made some progress, but the positive change in these indicators is small. Consequently, the gap between Sub-Saharan Africa and other regions has grown.

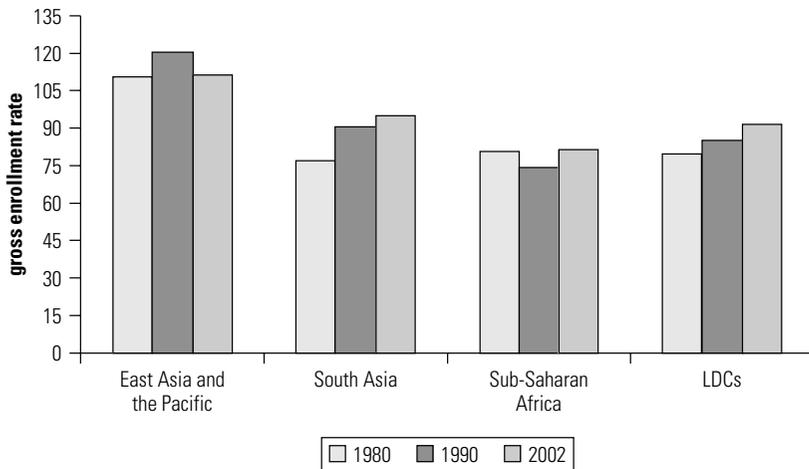
Indicators of literacy and basic education

Figures 2.9 and 2.10 show relative progress in literacy and basic education. In terms of attainment, East Asia and the Pacific has maintained its lead both in securing a more than 90 percent adult literacy rate and in achieving universal primary school education. The situation in South Asia is less encouraging. While South Asia has made progress in improving adult literacy rates from its low base during the past two decades (figure 2.9), this progress has not been as solid as its progress in raising incomes and improving life and death indicators. South Asia's adult literacy attainments have now reached the average



Source: World Bank central database.

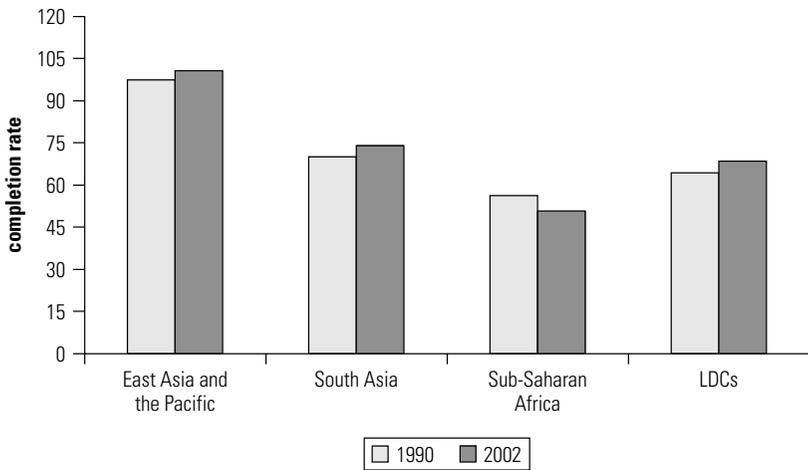
Figure 2.9 Adult Literacy Rate, Selected Regions and Years



Source: World Bank central database.

Figure 2.10 Primary School Enrollment, Selected Regions and Years

for low-income economies, but are somewhat lower than those in Sub-Saharan Africa and significantly below those in East Asia and the Pacific. This is one important example of weak public policy that must be addressed. The situation is slightly better in relation to basic education (figure 2.10). Primary school enrollment in South Asia has now



Source: World Bank central database.

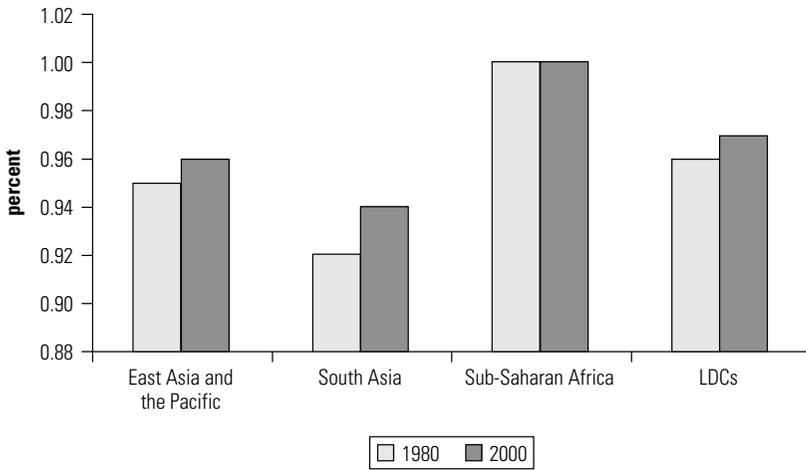
Figure 2.11 Primary School Completion Rate, Selected Regions, 1990 and 2002

grown to more than 90 percent, but progress with completion rates is weak (figure 2.11). Overall, literacy and primary education is a major area where public policy has been inadequate and a much stronger effort will be needed.

Indicators of gender balance

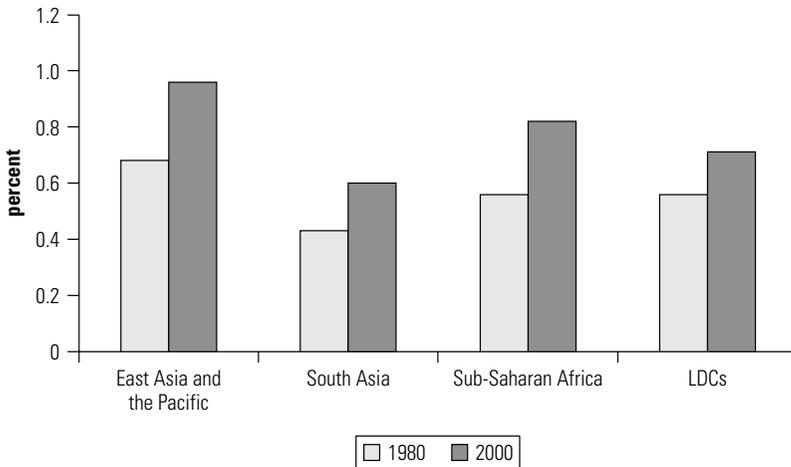
Inequality between males and females is a serious problem in many societies, and South Asia has a particularly poor reputation in this regard. Figures 2.12, 2.13, and 2.14 present a number of pertinent indicators.

Dreze and Sen (1995) argue that in any society, the female-male ratio would normally tend to exceed 1, reflecting females' biological advantage in terms of longevity. Indeed, this is the case in Europe and North America, where the ratio is around 1.05. In South Asia, however, as figure 2.12 shows, the ratio is significantly less than 1, although some improvement has taken place during the past 20 years. Considerable disparity is also apparent in the female-male literacy rate in South Asia (figure 2.13). The progress in closing this gap is somewhat weaker in South Asia compared with the full parity in East Asia and the Pacific and the better progress in Sub-Saharan Africa. The picture is somewhat better when one looks at girls' education relative to boys' (figure 2.14). South Asia has made stronger progress in reducing



Source: World Bank central database.

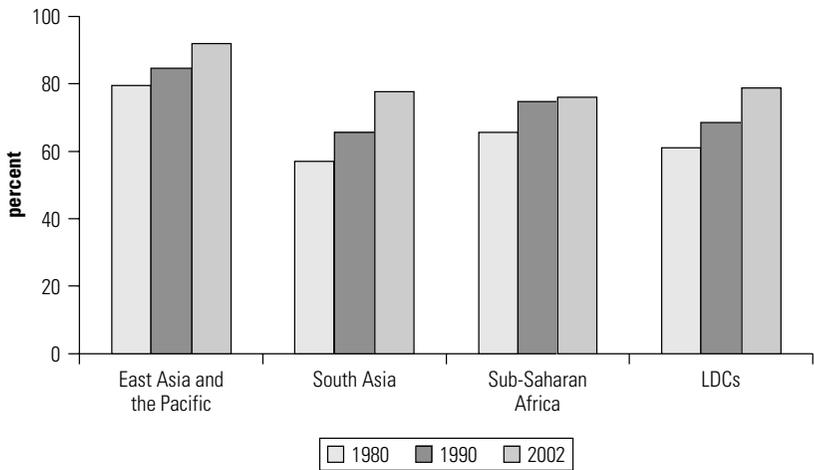
Figure 2.12 Female-Male Ratio, Selected Regions, 1980 and 2000



Source: World Bank central database.

Figure 2.13 Female-Male Literacy Parity, Selected Regions, 1980 and 2000

the gender gap in education than Sub-Saharan Africa, especially in the 1990s, catching up from its low levels in 1980. Overall, the story that emerges is that notwithstanding progress in reducing gender inequality, especially in reducing the female gap in education, the biases against females remain a key concern in South Asia.



Source: World Bank central database.

Figure 2.14 Girl-Boy Ratio in Primary and Secondary Education, Selected Regions and Years

Table 2.4 Indicators of Gender Disparity, South Asia, 1980 and 2000

Location	1980			2000		
	Female ratio	Female literacy	Girls' education	Female ratio	Female literacy	Girls' education
Bangladesh	0.92	0.43	0.77	0.99	0.62	1.07
India	0.93	0.49	0.66	0.94	0.66	0.74
Nepal	0.93	0.19	0.47	0.95	0.42	0.65
Pakistan	0.93	0.35	0.47	0.93	0.55	0.72
Sri Lanka	0.89	0.87	0.99	1.03	0.95	1.03
South Asian Regions	0.92	0.43	0.69	0.94	0.60	0.81
LDCs	0.96	0.56	0.72	0.97	0.71	0.83

Source: World Bank central database.

Note: All variables are ratios of females to males.

Important differences occur within South Asia, and table 2.4 shows indicators by country. Bangladesh and Sri Lanka have made the most progress in relation to gender equality, with Sri Lankan indicators similar to those of advanced countries. Bangladesh, however, continues to lag behind on female literacy. India, Nepal, and Pakistan have made some progress, but gender biases remain serious.

OVERALL ASSESSMENT OF PROGRESS

Overall, South Asia's progress with long-term development, especially over the past two decades, has been quite positive. Starting from a low income base, South Asia has succeeded in accelerating growth, reducing poverty, and improving human development. The pickup in growth is particularly encouraging and has contributed to a substantial increase in South Asia's share of global income. South Asia's development performance is better than the average performance in low-income economies in most areas; however, it falls short of achievements in the economies of East Asia and the Pacific. In addition, in a number of areas such as education and gender equality, the outcomes are weaker than the average for low-income economies. Evidence also indicates that income inequality has increased, reducing the impact of growth on poverty reduction.

Despite important differences between countries within the region, by and large all the major countries have made progress with development. India and Sri Lanka have led the way on growth, followed by Bangladesh. Bangladesh and Sri Lanka have led the charge on human development. Nepal and Pakistan have been the weaker performers, although Pakistan's growth performance showed signs of a turnaround in 2004 and 2005. Pakistan is now also giving more attention to human development than in the past.



3 Policies for Economic Growth

Growth, poverty, and human development are obviously interrelated. It is no accident that, on average, high-income economies tend to have lower poverty rates and better human development than low-income economies. Therefore, understanding growth dynamics and supporting the acceleration of incomes is perhaps the most fundamental policy challenge in low-income economies, including in South Asia. Yet without appropriate public policies, high incomes may not always lead to a better quality of life for all citizens (Dreze and Sen 2002). Also income inequality could reduce the effectiveness of income growth for poverty reduction. Thus policy intervention is necessary to strengthen the relationship between growth and poverty reduction (World Bank 2005a). To understand the factors that explain South Asia's past growth performance and identify areas of policy intervention for the future, this chapter seeks to explain the factors that have contributed to growth acceleration in the region.

SAVING AND INVESTMENT

In line with Spence's (2005) framework, we look at the determinants of investment and productivity as the basis for explaining growth in South Asia, starting with saving and investment efforts. Table 3.1 shows average rates for the 1970s, 1980s, and 1990s. As the table shows, saving and investment rates have generally exhibited a rising trend in South Asia and exceeded 20 percent of GDP during the 1990s.⁵ The average saving and investment rates grew further during 2000–3. Thus compared with the 1970s, saving and investment rates rose by 4 and 5 percentage points of GDP, respectively, during 1990–2003. This suggests that, consistent with most theories of growth, including the Spence approach, accelerated domestic capital formation was a major factor underlying the rise in per capita incomes in South Asia during 1980–2003. Bangladesh, India, Nepal, and Sri Lanka have all made persistent efforts to increase investment rates from their relatively low levels in the 1970s.

As figure 3.1 shows, the increase in the investment rate was driven largely by the private sector. This effort to increase the investment rate helped accelerate income growth in the South Asian countries. In Pakistan, the investment rate increased in the 1980s, which helped raise the growth rate, but the investment effort decreased during the

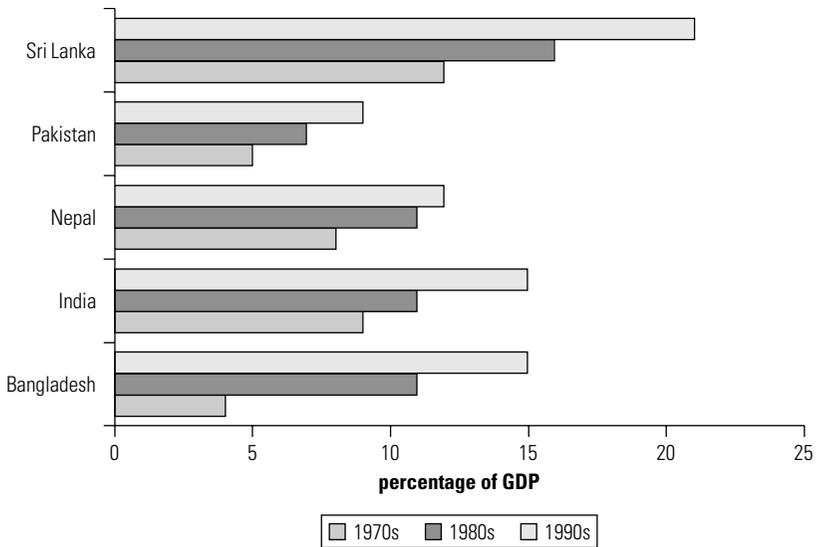
Table 3.1 **Saving and Investment Rates, South Asian Regions, 1970s–1990s**

(percentage of GDP)

Country	1970s		1980s		1990s	
	Saving	Investment	Saving	Investment	Saving	Investment
Bangladesh	7	11	15	17	19	20
India	18	18	20	22	22	23
Pakistan	11	16	16	19	16	18
Nepal	10	12	15	20	18	22
Sri Lanka	14	17	18	26	20	24

Source: World Bank central database.

Note: Investment represents gross national investment. Saving is defined as gross national investment less the current account balance. The rates are period averages.



Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.1 Gross Fixed Private Investment, South Asia, 1970s–1990s

1990s, which partly explains the deceleration of growth in Pakistan in the 1990s.

The financing pattern differs significantly from country to country. India has traditionally relied much less on foreign financing, and most investment is funded through national savings. Bangladesh has moved quickly to accelerate its saving rate from the low initial levels prevailing in the 1970s, and its saving effort is on a rising trend, with commensurate reductions in foreign financing. Nepal and Sri Lanka, however, continue to rely quite substantially on foreign saving. In Sri Lanka, this is a combination of foreign direct investment and official assistance. In Nepal, this is mostly a reflection of strong reliance on foreign aid on highly concessional terms. Pakistan relied quite heavily on foreign financing during the 1970s and the 1980s, often on market terms, contributing to a rapid acceleration in foreign debt and the debt service burden. When the debt crisis hit Pakistan in the 1990s, its ability to mobilize foreign financing was reduced. Along with its relatively low saving rate, this constrained Pakistan's investment efforts in the 1990s.

While rising, South Asia's saving and investment rates are still below the rates found in East Asian economies, especially China. The average investment rate in China during 1980–2003 was about 37 percent of GDP, compared with around 22 percent for South Asia. This has allowed China to sustain an average growth rate of 9.4 percent per year compared with 5.7 percent for South Asia. China's high saving rate also explains the seemingly paradoxical results that high growth can coexist alongside financial sector inefficiencies. This is simply a reflection of high domestic saving that is substituting for capital market inefficiencies.

POLICIES FOR INFLUENCING INVESTMENT AND ITS PRODUCTIVITY

As noted earlier in the context of the Spence framework, two areas of policy have a major influence on the level of investment and its productivity: macroeconomic stability and the investment climate.

Macroeconomic stability

There is now broad consensus that macroeconomic stability has major implications for investment and growth; however, debate continues about the role of individual instruments in achieving macroeconomic stability. The main issue concerns the level of fiscal deficits. For example, the coexistence of large fiscal deficits with high growth in India during the 1990s is cited as evidence that large fiscal deficits are not necessarily a constraint to investment and growth and that the policy prescription to reduce these deficits need not be a high priority (World Bank 2004c). Before turning to this issue, let us define macroeconomic stability. In the literature (Krugman and Obstfeld 2005), the concept of internal and external balance has been used to reconcile the objectives of full employment output with price stability (internal balance) and stability of the balance of payments (external balance). We know that the concept of full employment output is not very meaningful for low-income economies. Nevertheless, adequate empirical evidence indicates that high rates of inflation and large current account deficits will eventually lead to a growth crisis, possibly leading to a growth collapse. Accordingly, we will use trends in the inflation rate and current account deficits as the main indicators of macroeconomic stability.

Trend in inflation. Table 3.2 shows average inflation rates in South Asian countries compared with inflation in the world as a whole, Sub-Saharan Africa, and developing countries. The table shows a remarkable result. On average, South Asia countries have experienced lower rates of inflation than the world average and substantially lower than the average for developing countries. On balance, this is the result of prudent macroeconomic policies. A combination of exchange rate, monetary management, and fiscal policies has allowed the South Asian countries to keep inflation in the single digits over the past 34 years or so. This macroeconomic stability has contributed to investor confidence and supported the increase in the rate of investment.

Some differences are apparent intertemporarily and within countries. The rate of inflation has generally tended to be higher in Sri Lanka, and Bangladesh in the 1970s and 1980s and Pakistan in the 1970s experienced inflationary pressure that was higher than the South Asian average. India and Nepal have generally been cautious in containing inflationary pressures, although India faced a surge in inflationary pressure in the early 1990s that it soon brought under control through a major stabilization and structural reform program. The important point is that all the countries quickly moved to reduce inflationary pressures and keep the inflation rate well below the average for developing countries.

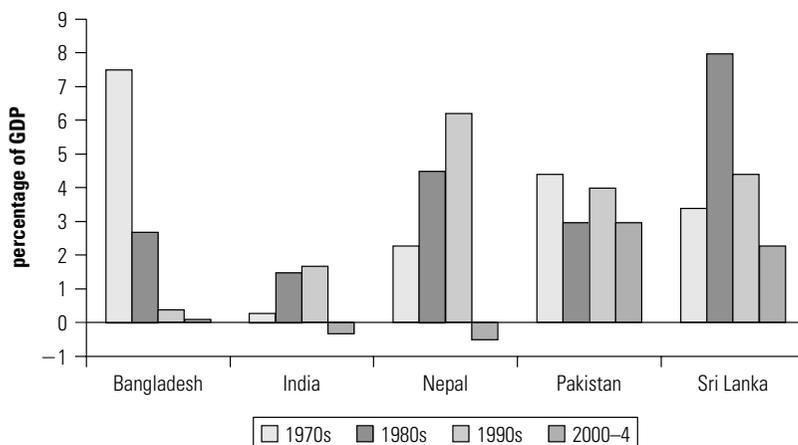
Table 3.2 **Trend in Inflation, Selected Countries and Regions, 1970–2004**
(percent per year)

Location	1970s	1980s	1990s	2000–4
Bangladesh	19.3	10.4	5.2	4.6
India	7.8	8.9	9.0	3.8
Nepal	7.6	10.1	8.8	3.3
Pakistan	12.2	7.0	9.2	4.1
Sri Lanka	8.7	12.2	9.7	9.7
Sub-Saharan Africa	13.0	15.9	18.8	8.0
Developing countries	23.0	35.6	25.6	5.9
World	13.2	14.2	12.0	3.8

Source: IMF 2000, 2001, 2002, 2003, 2004.

Trend in current account deficits. Figure 3.2 shows the average level of current account deficits in the South Asian countries. Except for the crisis year of 1991, India generally maintained low current account deficits, reflecting its extreme prudence in external borrowing and a somewhat conservative stance toward foreign capital inflows, including foreign direct investment. When faced with the external payments crisis in 1991, India took strong corrective actions that restored the stability of the balance of payments (Acharya 2002). Progress since then has been remarkable, and the current account turned into a surplus in 2000–4. Bangladesh received large injections of foreign aid inflows on concessional terms in the 1970s, following its independence, which explains the surge in current account deficits during this period.

However, since the 1980s, Bangladesh has cut its current account deficits sharply, and they stood at less than 1 percent of GDP in 2000–4. Nepal has benefited from large official capital inflows at concessional terms, which explains its deficits during 1970–99. Nepal converted these deficits into a surplus in 2000–4 by benefiting from large inflows of remittances. Sri Lanka has similarly benefited from access to concessional assistance, but it has also maintained a more liberal stance toward capital inflows, which explains its generally large



Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.2 Trend in Current Account Deficits, South Asian Countries, 1970–2004

current account deficits. Even so, the surge in the deficit became unsustainable in the 1980s, and Sri Lanka took steps to reduce it to more sustainable levels. One common thread running through all these country experiences is that all the countries took steps to increase their debt servicing capacity. Thus even as the ratio of external debt to GDP grew, debt servicing capacity also grew (table 3.3). Consequently, none of these countries faced any serious balance of payments crisis on a long-term basis.

Pakistan's experience is, however, different and telling. A combination of large current account deficits during 1970–96, often financed with nonconcessional official assistance, combined with a liberal attitude toward foreign capital inflows, led to a surge in external debt and debt servicing payments (Ahmed 1994). This eventually resulted in an external payments crisis during 1998–2000, because commensurate improvements in debt servicing capacity did not occur (Ahmed 2002b). Growth was seriously disrupted in the 1990s. Reform efforts since 1997, along with debt restructuring support, have finally succeeded in reversing the balance of payments crisis and restoring the growth momentum as discussed in more detail later.

Summary on macroeconomic stability

The story that emerges on macroeconomic stability in South Asia is that, on the whole, the South Asian countries have maintained a stable macroeconomic environment. Inflation rates have been lower than the world inflation rate and substantially lower than in developing countries as a whole. Except in India during 1991 and in Pakistan, the external payments situation has been stable, with current account deficits based largely on the availability of concessional foreign assistance. Commensurate improvements in debt servicing capacity enabled servicing of the accumulated debt, mostly on concessional terms. This stability of the macroeconomic environment has been a key factor supporting the growth in investment and ensuring its sustainability. In the case of Pakistan, its experience suggests that unsustainable foreign borrowing may allow rapid growth for a while, but that a subsequent external payments crisis will hurt the growth momentum and reforms to correct the external imbalance will be necessary to revive the growth effort. This once again indicates the critical importance of macroeconomic stability for sustained growth.

Table 3.3 **External Debt Indicators, South Asian Countries, Selected Years**
(percent)

Country	Debt/gross national income				Debt/exports of goods and services				Total debt service/exports of goods and services				Interest payments/exports of goods and services			
	1980	1990	1999	2003	1980	1990	1999	2003	1980	1990	1999	2003	1980	1990	1999	2003
Bangladesh	22	40	34	34	276	428	204	169	17	26	9	7	5	7	2	2
India	11	27	22	19	137	325	153	101	9	32	16	18	4	19	6	5
Nepal	10	45	59	56	75	367	213	174	3	16	8	6	2	6	2	2
Pakistan ^a	39	50	54	45	185	231	334	192	16	21	29	16	7	9	10	4
Sri Lanka	46	75	64	57	123	210	145	126	12	19	11	7	6	7	3	2

Source: World Bank central database.

a. Pakistan's total debt service accelerated to 35 percent of exports of goods and services in 1997. Reforms and debt restructuring brought this down in subsequent years.

Progress with macroeconomic policies

Given this background, what are the specific policy implications for ensuring the stability of the macroeconomic framework? Drawing from the textbook analogy of internal and external stability in an open economy, the interaction of three key policies—monetary policy, exchange rate management, and fiscal policy—is particularly influential for macroeconomic stability. These policies are obviously interrelated, and other policies such as trade policy and financial sector policy are also relevant for ensuring macroeconomic stability. This section focuses on the first three policies and considers the other two when discussing the investment climate.

Monetary policy. In his famous work on the quantity theory of money, Friedman (1973, p. 62) states that “inflation can be prevented if and only if the stock of money per unit of output can be kept from increasing appreciably.” Experiences with hyperinflationary episodes demonstrate this result particularly strikingly (see, for example, Cagan 1974). While leads and lags will explain the divergence between the growth of money and of prices in the short term, over the long run, the rate of growth of inflation is highly correlated with the rate of growth of money.

Table 3.4 illustrates this situation for the South Asian countries. Not surprisingly, over the long term, inflation is driven by the difference between the rate of growth of real GDP and of the money supply. On average, the South Asian countries have maintained a prudent stance on monetary expansion, thereby keeping inflation low. A lower pace of inflation supported by a lower rate of growth of money supply has been good for growth. Thus India has tended to have higher growth and lower inflation than other South Asian countries, supported by a lower pace of monetary expansion. Similarly, Bangladesh reduced its rate of monetary expansion over time in line with inflation targets, while achieving higher GDP growth. Pakistan has brought down inflation by monetary tightening (as explained earlier, the reduction in growth was caused partly by the unsustainable external debt situation). In Sri Lanka, monetary tightening also helped reduce inflationary pressures in the 1990s while growth increased. Nepal as well reduced inflationary pressures in the 1990s by monetary tightening.

Table 3.4 **Growth of Money, GDP, and Inflation, South Asian Countries, 1970–2004**
(percent per year)

Country	1970s			1980s			1990–2004			1970–2004		
	Money	GDP	Inflation	Money	GDP	Inflation	Money	GDP	Inflation	Money	GDP	Inflation
Bangladesh ^a	16	3	15	13	4	10	11	5	5	14	4	10
India	12	3	8	15	6	9	14	6	7	13	5	7
Nepal	15	2	8	17	5	10	13	4	7	14	3	8
Pakistan	17	5	12	14	6	7	13	4	7	14	5	9
Sri Lanka	17	4	9	16	4	12	11	5	6	14	5	8

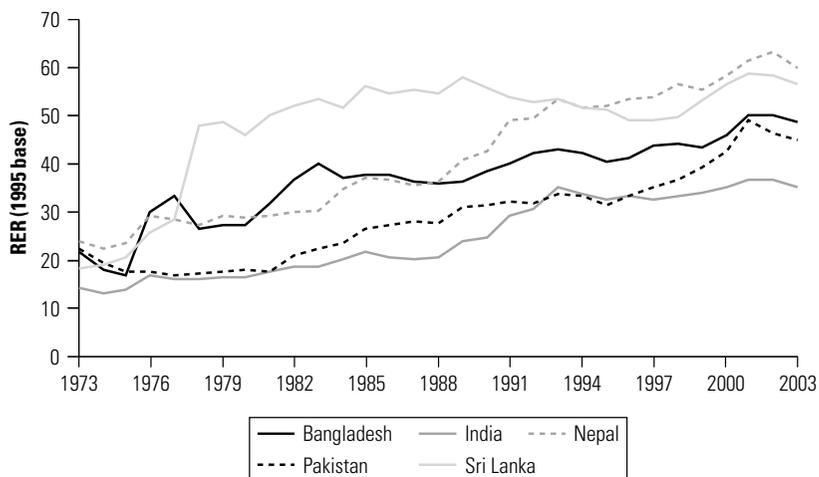
Source: Money and inflation data: IMF 2000, 2001, 2002, 2003, 2004; GDP growth data: World Bank central database.

Notes: Money is defined as M1.

a. 1970s refers to 1974–80. Inflation measured by the GDP deflator as the consumer price index is not reliable for this period. Data are from World Bank (1993).

Exchange rate management. Just as price stability over the longer term is impossible without monetary stability, balance of payments stability is impossible without flexible management of the exchange rate. The degree of flexibility of the nominal exchange rate can, of course, vary, depending upon a country's circumstances, but a fixed nominal exchange rate will likely not be sustainable over the long term and could cause major disruptions to the growth process. In the short term, the fixity of the nominal exchange rate is often advocated as part of a heterodox macroeconomic management strategy to control high rates of inflation in economies where wages are indexed. The exchange rate acts as a nominal anchor to check the spiral effects of an inflationary episode. As noted, the South Asian countries have generally maintained low inflation and also wages are not fully indexed to price changes, so the search for a nominal anchor is not compelling. In an environment of open capital accounts, interest rate policy will also have an important role to play in influencing balance of payments outcomes through its effect on capital flows. The South Asian countries generally restrict capital flows heavily. The extent of restrictions varies by country, with Pakistan and Sri Lanka being relatively less restricted than Bangladesh, India, and Nepal. Thus the direct influence of interest rates on the balance of payments is likely to be small; however, the effects of monetary policy on the interest rate and on aggregate demand have substantial implications for balance of payment outcomes.

As the "real" exchange rate is what influences the balance of payments, the coordination of monetary and exchange rate policy is important. Figure 3.3 shows trends in the real exchange rate for the South Asian countries. The figure suggests that following periods of inconsistent exchange rate policy in the 1970s and 1980s, the South Asian countries generally maintained a flexible stance in relation to the nominal exchange rate in the 1990s. Even during 1970–80, most South Asian countries avoided long episodes of real exchange rate appreciation. This flexibility of the real exchange rate has contributed significantly to the growth of exports and stability of the balance of payments in most South Asian countries. In Pakistan, imprudent fiscal and monetary policies during 1970–96 and the large external debt overhang resulting from excessive reliance on nonconcessional external financing limited the effectiveness of exchange rate management in supporting external stability.



Source: Author's calculations using basic exchange rate and price data from the IMF.

Figure 3.3 Trends in the Real Exchange Rate, South Asian Countries, 1973–2003

Fiscal policy. With a relatively closed capital account, as in the South Asian countries, fiscal policy would tend to be assigned to supporting growth and employment, monetary policy to price stability, and exchange rate management to balance of payments stability, but this is a somewhat simplified approach. In practice, open economies need to adopt a coordinated approach to monetary, fiscal, and exchange rate management to ensure both internal and external stability. In the absence of an integrated approach, the role of fiscal policy can easily be misunderstood. For example, the coexistence of a large fiscal deficit and high growth is sometimes seen as evidence that macroeconomic stability is not a necessary condition for sustained growth. In another version, such coexistence is cited as an example of a trade-off between growth and macroeconomic stability in line with the Phillips curve hypothesis (Phillips 1958). The experience from South Asian countries offers some useful insights in this context.

Table 3.5 presents the pattern of movement in the fiscal balance in the South Asian countries and shows a number of interesting results. First, fiscal management has been a difficult challenge in all the South Asian countries, especially during the 1970s and 1980s. Many of the difficulties have resulted from relatively low revenue efforts, but weak expenditure policies have also contributed. The fiscal problem was

Table 3.5 **Trend in Fiscal and Primary Deficits, South Asian Countries, 1970–2004**
(percentage of GDP)

Country	1970s		1980s		1990s		2004	
	Fiscal	Primary	Fiscal	Primary	Fiscal	Primary	Fiscal	Primary
Bangladesh	1.2	0.9	5.4	4.4	4.8	3.5	4.2	2.5
India	6.0	4.0	9.1	5.5	7.9	2.7	9.8	3.3
Nepal	5.0	4.5	9.7	8.7	6.8	5.4	2.9	1.4
Pakistan	9.0	7.4	6.7	3.4	7.8	1.2	4.0	−3.0
Sri Lanka	7.0	5.0	10.1	5.1	8.1	2.1	8.6	2.1

Source: World Bank regional database; International Monetary Fund data.

Note: Figures are period averages.

compounded in the 1990s by the growth of public debt, which caused a substantial amount of resources to be diverted to interest payments. Second, policy efforts in the 1990s attempted to correct the large fiscal imbalances, as reflected in declining primary deficits, but with varying degrees of success. Third, the fiscal correction has been broadly successful in Bangladesh, in Nepal, and more recently in Pakistan. Success has been more limited in Sri Lanka and completely elusive in India. Indeed, many have cited the prevalence of large fiscal imbalances in India along with rapid growth as an example of what is wrong with the Washington consensus, that is, its insistence on low fiscal deficits as a policy priority. Is this a fair criticism of the Washington consensus? Is it alright for India to keep on running these fiscal deficits? Are these deficits supporting high growth in India?

The analytical basis for using fiscal deficits to promote growth is provided by the Keynesian view that in an economy with unemployed resources, demand creation through fiscal stimulus could boost growth. The consistency of this policy prescription with macroeconomic stability was not initially a concern, because the original formulation came in the context of a closed economy with price rigidities. However, this analysis was soon converted to the case of an open economy with flexible prices, leading to fiscal policy focusing on income and employment, monetary policy focusing on price stability, and exchange rate policy focusing on external stability (assuming international capital immobility).

Let us examine the relevance of this framework for the South Asian countries, starting with India. A simple approach would seem to validate this view. Growth did pick up substantially in 1980–2004 along with large and rising fiscal deficits. Inflation was contained through prudent monetary management, and external balance was maintained through low external borrowing and a competitive real exchange rate. However, this is too simplistic a view and does not withstand careful scrutiny. In line with theory, and depending upon how the deficits are financed, large fiscal deficits would tend to become unsustainable because (a) if deficits are financed by domestic borrowing, then they would tend to crowd out private investment by raising domestic interest rates; (b) if deficits are financed by money creation, then this will exacerbate inflation; and (c) if deficits are financed through external borrowing, they will contribute to a balance of payments crisis. In the case of India, large fiscal deficits did contribute to the 1991 macroeconomic crisis (Krueger and Chinoy 2002; Srinivasan 2002). Subsequently, deregulation reforms, a flexible exchange rate and deft monetary management contained the adverse effects of high deficits on macroeconomic stability. Furthermore, a good part of the deficits was financed through nonbank domestic sources, which explains why these deficits did not contribute to high rates of inflation or to balance of payments pressures.

Pinto and Zahir (2003) have researched the effects of this on interest rates and private investment. They conclude that indeed, evidence indicates that large fiscal deficits in India have put pressure on the real interest rate and crowded out private investment. Other studies have reached similar conclusions (Reynolds 2001; World Bank 2000). In the past, government control over interest rates through banking dominated by the public sector made diverting resources to the public sector at low cost easier. With the recent, gradual liberalization of financial markets, the crowding out effects could become more severe than in the past.

In the short term, with excess capacity, a generalized demand stimulus could lead to growth acceleration. Over the longer term, the growth impact will depend upon whether or not fiscal deficits are used to finance investments that complement private investment, for example, in infrastructure, and the degree of crowding out. In the case of India, some evidence indicates that a fiscal stimulus did boost

growth in the 1980s. Liberalization policies created incentives to utilize existing capacities better and a fiscal stimulus created the demand for this (Srinivasan 2002), but over the longer term, these deficits have constrained growth (Acharya 2002, 2005; Ahluwalia 2002a, 2002b; Ferro, Rosenblatt, and Stern 2004; Srinivasan 2002; World Bank 2003c). This is partly because the growing public debt has created a huge debt servicing burden, for example, interest costs as a percentage of GDP grew from around 2 percent of GDP in the 1970s to more than 6 percent in 2004. Also much of the fiscal deficit is financing current spending, including subsidies. The shrinking fiscal space has seriously limited the capacity to finance investments in infrastructure and human capital at both the federal government and state government levels. The situation at the state level has now reached alarming proportions for many states, seriously constraining development prospects (World Bank 2005d).

The dangers for sustainable growth and development of running high fiscal deficits are illustrated dramatically in the case of Pakistan (Ahmed 1994). Between 1970 and 1990, Pakistan ran large fiscal deficits (table 3.5). This resulted in a rapidly growing debt to GDP ratio. Unlike India, Pakistan relied extensively on external financing. The rising debt service ratio caused the interest costs of debt to rise from less than 2 percent of GDP in the early 1970s to more than 7 percent in the 1990s. Commensurate increases in debt servicing capacity (exports and domestic revenues) did not take place (Ahmed 2002b). As a result, the balance of payments and fiscal pressures mounted in the 1990s. For example, debt servicing and defense spending consumed some 75 percent of total domestic revenues during most of the 1990s, leaving little space for development spending. Efforts to correct these large imbalances proved unsuccessful until 1997, partly because of political turmoil. In 1998, Pakistan exploded a nuclear device, which led to the imposition of sanctions by the Group of Seven. Along with an already fragile balance of payments situation, this triggered an external payments crisis as new capital inflows virtually dried up.

Fortunately, since mid-1997, a reform program to correct the macroeconomic imbalances was already under way. With the provision of financing support from the international financial institutions, Pakistan averted an external payments crisis. The military government

that came to power in October 1999 continued and strengthened the reform program. The resultant fiscal turnaround has been remarkable (table 3.5). As for the effect on growth, the fiscal stimulus of the 1970s and 1980s boosted growth during those decades, but the price of adjustment was paid in the 1990s. While other factors such as political turmoil, adverse weather conditions, and the Group of Seven sanctions all contributed to the decline in the growth momentum, the large magnitude of the fiscal correction sharply curtailed public investment, thereby reducing growth.

Sri Lanka's experience tells a similar story, that is, that large deficits are unsustainable in the long run, although the adverse effects on long-term growth have been less striking than in Pakistan. The large deficits of the 1970s and 1980s put tremendous pressure on the debt servicing burden in the 1990s. Fortunately, much of the foreign financing was on concessional terms. Also Sri Lanka was much more successful in opening up its trade regime and increasing its exports than Pakistan. As a result, the pressure of large deficits was mostly felt in the domestic economy. The growing interest costs of fiscal deficits along with the civil war in the northeast sharply reduced Sri Lanka's ability to finance public investment, which fell by 3 percentage points during the 1990s, adversely affecting growth.

Thus the evidence from South Asian countries that large fiscal deficits are not a sustainable way to finance growth is convincing. A fiscal stimulus could provide a short-term boost to growth, but if deficits remain unchecked, they could seriously affect macroeconomic stability or lead to a crowding out of private investment. What matters more for growth is the quality of public spending, not necessarily the level of spending.

INVESTMENT CLIMATE

The overall investment climate affects incentives for domestic and foreign private investment (World Bank 2004b). With a rapidly changing global economy where capital has become increasingly mobile, investment climate issues have become increasingly important. China's receipt of the largest share of foreign direct investment in the developing world is no accident and is driven primarily by the attractiveness of China's overall investment climate relative to that of its com-

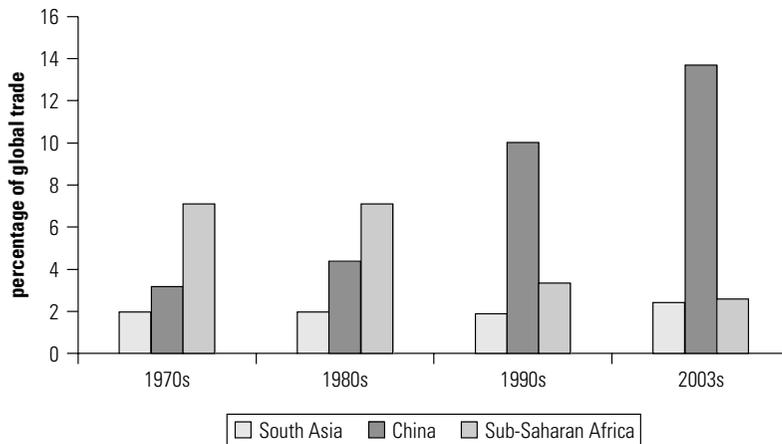
petitors. Several factors influence the attractiveness of the investment climate: the access to markets, the costs of doing business, the availability of infrastructure, and the access to finance.

Market access

The classical economists understood that trade was good for a country's welfare. Ricardo (1963) provided the analytical underpinnings of this relationship between trade and welfare in his theory of comparative advantage. Concerns about protecting domestic employment and wages saw the emergence of trade protection during the early 19th century. The second half of the century witnessed a revival of interest in trade liberalism, which has now gained momentum in the wake of moves toward greater global trade and economic integration. From an investor's point of view, the rationale for trade liberalization lies in the incentives that this provides. On the input side, ability to procure from the world's cheapest supply source is a great incentive. In addition, liberalization permits access to global innovation and technology that is not possible in a closed economy. On the output side, access to global markets provides opportunities for scale economies and benefits from higher demand based on higher incomes. China's experience with export-led growth is a good example of the benefits of trade and investment liberalization for developing economies.

The World Bank (2004g) provides a comprehensive review of trade policies in the South Asian countries, which, on the whole, started the early part of their development experience with a heavy dose of trade protection, making liberal use of quantitative and nonquantitative restrictions. The rationale for this was partly to protect domestic industries and employment and partly to raise revenues for the government (by means of high tariffs). Unhappiness with the outcome of these protectionist policies led to a gradual dismantling of the various trade protection instruments. Different countries moved at varying speeds. Nepal and Sri Lanka moved the fastest, followed by Pakistan in the 1990s. Bangladesh and India moved more slowly, and still remain relatively more heavily protected than most other low-income economies. But remarkably, the reduction in trade protection in South Asia between 1980 and 2003 was among the greatest in the developing world.

Figure 3.4 shows the impact of this policy. In the 1960s, the South Asian countries accounted for 1.9 percent of global trade, compared



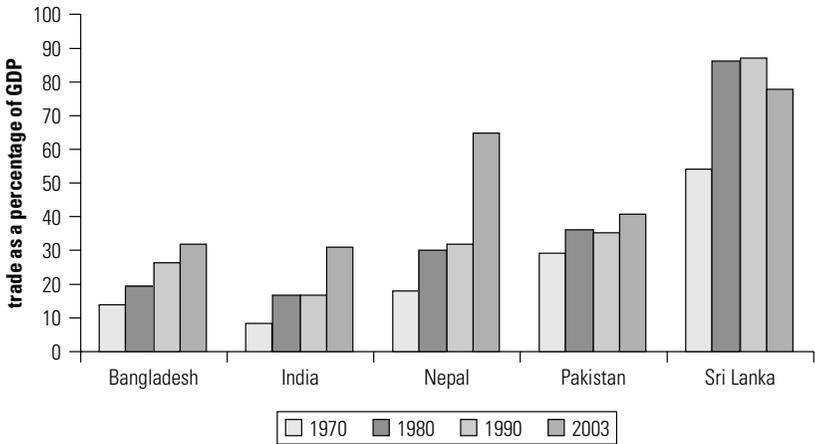
Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.4 Global Trade Shares, China and Selected Regions, Selected Years

with 3.2 percent for China and 7.1 percent for Sub-Saharan Africa. This did not change much during the 1970s and 1980s, revealing the continued heavy trade protection. The substantial reforms in trade policies occurred in the 1990s, especially in the large countries of Bangladesh, India, and Pakistan. Reflecting this, the South Asian share of global trade slowly started rising, and by 2003 had risen to 2.4 percent. Despite the small size of the increase, especially in comparison with the increase in China's share of global trade, it contrasts with the sharply declining share of Sub-Saharan Africa. It also indicates the potential for doing better in the future with continued trade reforms, especially in the larger countries of Bangladesh, India, and Pakistan.

Figure 3.5 illustrates the effect of the varying pace of trade liberalization in the different South Asian countries. Not surprisingly, Nepal, Pakistan, and Sri Lanka have higher shares of trade as a percentage of GDP than Bangladesh and India, reflecting the faster pace of trade liberalization in the former.⁶ In Bangladesh and India, trade liberalization gained momentum in the 1990s, but trade nevertheless remains much more protected in these countries than in Nepal, Pakistan, and Sri Lanka.

Trade reforms are an important factor contributing to improved incentives for private investment in the South Asian countries. The



Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.5 Trade Openness, South Asian Countries, Selected Years

import-substituting industrialization strategy that India and Pakistan pursued from 1947 to 1990 and that Bangladesh followed from 1972 to 1990 did not allow these large South Asian countries to gain much benefit from the global expansion of incomes and trade (Srinivasan 2001). With their opening up in the 1990s, exports expanded in Bangladesh and India, and this rapid expansion of exports was an important contributor to higher growth in the 1990s. Pakistan could not benefit fully from its trade liberalization until early 2000 because of the offsetting effects of adverse macroeconomic developments. However, evidence now indicates that things are turning around in Pakistan and that exports are responding to better incentives resulting from the exchange rate flexibility and the removal of trade protection. The distributional effects of trade liberalization also appear to be beneficial. For example, Ahmed and Sattar's (2004) study of the impact of trade openness on growth and poverty reduction in Bangladesh finds significant evidence of a positive relationship. Stern (2002) finds positive effects of trade liberalization on rural wages in India.

Costs of doing business

Several factors affect the costs of doing business, and they vary in relative importance from country to country. The World Bank has undertaken reviews of the costs of doing business as perceived by

surveyed investors in specific countries in the context of investment climate assessments. Even though these reviews are subjective and may reflect preconceived biases, their findings provide useful initial insights on the possible constraints to a good investment climate in terms of transaction costs (though currently they present a snapshot, and time series data are not available). Even so, cross-country and/or regional perspectives on transaction costs provide one explanation of why average investment may tend to be higher or lower in particular countries and regions.

The investment climate assessments typically look at 18 indicators in terms of the percentage of firms identifying these indicators as major or severe obstacles to business operation and growth. Data for 2002 for East Asia and the Pacific, South Asia, and Sub-Saharan Africa are shown in table 3.6. The table shows an interesting, but consistent, pattern. On the whole, investors' perceptions of the ease of doing business are most favorable for East Asia and the Pacific, followed by South Asia, and are weakest for Sub-Saharan Africa. For example, a third or more of the respondent firms rate 11 areas (61 percent of the indicators) as severe concerns in Sub-Saharan Africa, but rate only 5 areas (28 percent) in South Asia and 3 areas (16 percent) in East Asia and the Pacific as severe concerns. The perception gap between South Asia and East Asia and the Pacific on the one hand and Sub-Saharan Africa on the other hand is particularly large in such major areas as macroeconomic stability, availability of infrastructure, tax policy, and availability and cost of financing.

The deregulation drive in South Asia. The perception differences between East Asia and the Pacific and South Asia are, on average, low for most indicators, which is probably explained by the progress South Asia made in many of the areas during the 1990s. In particular, the fact that only 15 percent of the surveyed firms identified business licensing and operating permits as a constraint reflects the rapid pace at which the so-called "license raj" were dismantled in Bangladesh, India, and Pakistan during the 1990s. This is a remarkable result for South Asia, because even as recently as the 1980s, these countries were viewed as overregulated economies that stifled competition through heavy regulatory barriers to business entry. The deregulation drives that started in the 1990s have been a hallmark of policy reforms in South Asia over

Table 3.6 **Summary Investment Climate Assessment Indicators, 2002**
(percentage of responding firms)

Constraint indicator	East Asia and the Pacific	South Asian Regions	Sub-Saharan Africa
Economic and regulatory policy uncertainty	36	32	42
Macroeconomic instability	35	27	51
Corruption	36	40	48
Crime, theft, and disorder	25	22	34
Anticompetitive or informal practices	24	22	37
Legal system and conflict resolution	27	—	28
Telecommunications	15	11	28
Electricity	26	42	54
Transportation	17	16	23
Access to land	13	17	30
Tax rates	31	33	63
Tax administration	25	35	47
Customs and trade regulations	20	24	35
Labor regulations	21	16	15
Skills and education of workers	21	15	28
Business licensing and operating permits	18	15	15
Access to financing	18	28	47
Cost of financing	22	33	63

Source: World Bank.

— = Not available.

the past 15 years or so and have been a major contributor to improved incentives for private investment (Ahmed 2005; Forbes 2002; Klien and Palanivel 2002; Krueger and Chinoy 2002).

Other factors contributing to the high costs of doing business in South Asia. One major problem area in South Asia is the availability of electricity. More than 42 percent of firms identified this as a severe constraint to investment. More broadly, a detailed review of investment climate assessments for South Asian countries shows that infrastructure in general (power, roads, and ports) is a major constraint to investment (World Bank 2003b, 2004d). Another key concern that gets a consistently high response in all three regions is the problem of

corruption, although a much higher percentage of firms identify this as a major constraint in Sub-Saharan Africa than in East Asia and the Pacific and South Asia. Within South Asia, the perception of corruption is especially problematic in Bangladesh relative to that in India and Pakistan, although it remains a substantial concern in these countries as well. Other notable areas of concern in the South Asian countries include tax rates and administration, cost of finance, and policy uncertainties. While recent progress in the banking sector has helped reduce the cost of finance for large borrowers, this is a serious problem for medium and small enterprises, especially in rural areas (Shilpi 2005). Issues relating to corruption, tax rates and administration, and policy uncertainties are a part of the broader problem of public sector performance and are dealt with in chapter 5.

The infrastructure challenge

The investment climate assessment responses reinforce Spence's (2005) emphasis on infrastructure as a necessary condition for growth. Several studies looking at India's growth prospects identify infrastructure as one of the most important constraints to future rapid growth (Ahluwalia 1998, 2002a; Krueger and Chinnoy 2002; McKinsey Global Institute 2001). This is easy to understand, because in this era of global competition, good infrastructure can make the difference between a competitive firm and a noncompetitive firm. For example, a World Bank (2005b) study of horticulture export prospects for India shows dramatically how poor infrastructure constrains the expansion of this potentially high-growth export activity. More broadly, the state of infrastructure is a problem in all the South Asian countries. In recent years, considerable progress has been made in improving telecommunications services through deregulation and privatization (Sundar and Deb 2001), but electricity and transport services are serious concerns (Briceno-Garmendia, Estache, and Shafik 2004).

The poor performance of the power sector has been a major problem in all the South Asian countries. The source of the difficulty is similar in all the countries, that is, the provision of electricity by weak and inefficient public entities. The problem is compounded by government control over prices and poor sector governance. As a result, the entities are financially constrained, have serious generation and

transmission losses (mostly because of theft), and have low installed capacities as a result of inadequate investment. Indeed, over the years, the capacity of the electricity utilities to finance investment from their own resources has weakened, leading to substantial reliance on the government. Governments' fiscal problems, particularly in India, are partly a reflection of high subsidies to electricity entities. The growing fiscal deficits have in turn constrained the ability to fund the required investment in the electricity sector as well as in other infrastructure. Efforts to reform these entities have met with limited success (Sundar and Deb 2001). This is mainly because reforms have not addressed the fundamental constraint, that is, electricity must be viewed as a commercial product that should largely be produced and priced based on demand and supply, although appropriately modified through regulatory policies to protect public interests. The principles are well known, but political constraints have prevented fundamental reforms.

In transport, the problems relate mostly to roads and ports. In the case of roads, including highways, the main constraint is funding of both new investments and maintenance because of governments' fiscal problems. In the case of ports, the issues are partly funding, but also weak efficiency and poor governance on the part of port authorities.⁷

Given the backlog, the investment needs for infrastructure are large. For example, one study (Fay and Yepes 2004) estimates annual investment needs of US\$63 billion (6.9 percent of GDP) for South Asia for new investments and maintenance. Whatever the methodological issues with these estimates, investment requirements are clearly large. Given the constrained fiscal situation of the South Asian countries, for all these investments to come from the public sector is simply not possible. Even with heady progress with fiscal reforms, not an easy task, the infrastructure financing gap will be substantial. Thus infrastructure investment will require strong public-private partnerships, yet the private provision of infrastructure is a major challenge in the South Asian countries. Experience is limited and mostly not encouraging because of weak institutional capacity and corruption (see, for example, Ahmed 2002b for a discussion of the experience of private power producers in Pakistan). Establishing the capacity to develop, negotiate, regulate, and monitor private infrastructure arrangements is an important institutional challenge for the South Asian countries.

Access to finance

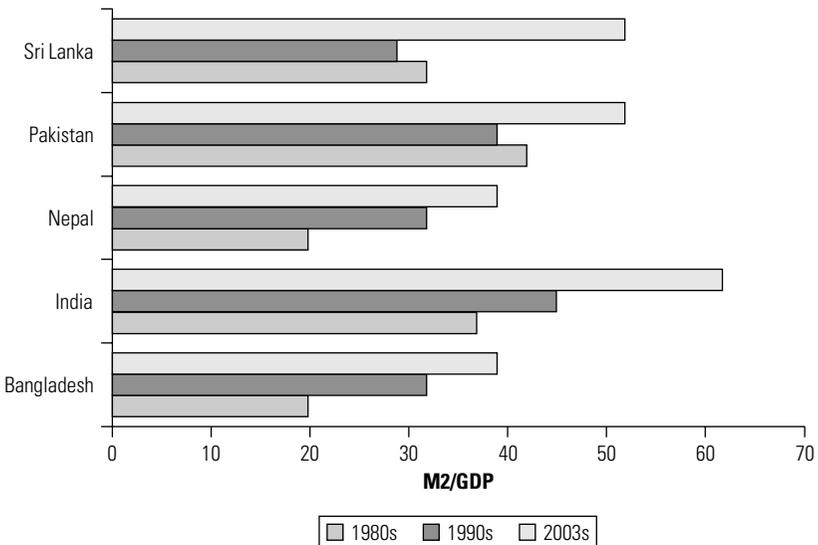
Financial sector performance is recognized as a major determinant of the growth of the private sector in any modern economy. International evidence shows that over the long term, economic development and the maturity of the financial sector are strongly correlated (Calderon and Liu 2003; Department for International Development 2004; Khan 2002; Khan and Senhadji 2000; Levine 1997; Loayza and Ranciere 2004).⁸ In today's world of global markets and competition, the cost and efficiency of financial services can often make the difference between a competitive and a noncompetitive firm. In low-income economies, banking enterprises typically dominate the financial sector. Nonbank financial institutions normally tend to be at an evolutionary stage. So much of the financing for private enterprises is provided by the banking sector, and consequently, the performance of the banking sector is a key determinant of the growth of the private sector.

Ahmed, Ramachandran, and Uy (2003) provide a detailed review of banking sector performance in South Asia. More recent updates at the country level are available for Bangladesh (Ahmed 2005), India (Basu 2005), and Pakistan (IMF and World Bank 2005). The basic storyline that emerges from these studies is as follows. The South Asian countries have historically relied extensively on public sector ownership of banks, and the allocation of credit and its pricing have been heavily regulated. Government interventions in banking have been motivated partly by the need to finance public sector deficits at controlled interest rates and partly by efforts to guide credit to so-called priority activities, including the financing of nationalized enterprises. Private banking started growing only after the liberalization policies of the 1990s. The pace of banking reforms has varied by country. While deregulation of interest rates and more liberal entry of the private sector began in the 1990s, reforms of public banks and strengthening of prudential regulations started much later. Overall, India and Sri Lanka have been early reformers, followed by Pakistan and, more recently, by Bangladesh. Nepal still has a fragile banking sector, although reform efforts started recently. Even though Pakistan only initiated serious banking reforms in 1997, it has made the most progress in reducing the dominance of public banks through privatization as well as through new private banks. India and Sri Lanka started reforms in

the early 1990s, but did not push privatization. Instead they promoted banking reforms through better regulations, greater competition from private banks, and interest rate deregulation. Banking reforms in Bangladesh began in earnest only in 2002, but progress has been fairly rapid, mostly in the private sector. Efforts to privatize the public banks are just starting.

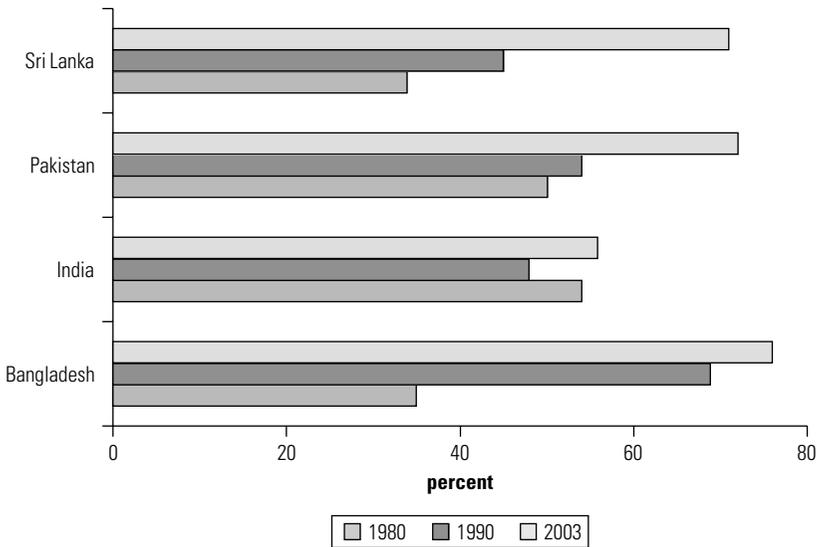
Figure 3.6 shows progress with deepening of the banking sector measured in terms of the ratio of M2 to GDP. In all the South Asian countries, penetration of the banking sector has deepened. During the 1990s, this progressed most rapidly in India and Sri Lanka. The countries also made progress in improving the allocation of credit, as reflected by the rising share of private credit to total bank credit (figure 3.7). This was the result of allowing more competition in banking, but was also due to reduced government intervention in the allocation of credit.

Perhaps the most telling improvement was the strengthening of portfolio quality and banking stability in recent years. One key indicator of portfolio quality and banking stability is the share of nonperforming loans in total loans. Years of public ownership and weak management landed the South Asian banking sector in a messy



Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.6 Financial Depth, South Asian Countries, Selected Years



Source: IMF 2000, 2001, 2002, 2003, 2004.

Figure 3.7 Share of the Private Sector in Total Credit, Selected South Asian Countries and Years

situation in terms of large nonperforming loans, posing huge risks for financial stability. The weakness of the banking sector alone would have exposed the South Asian countries to serious downside risk when the East Asian financial crisis happened in the late 1990s. This was averted mainly because of otherwise prudent macroeconomic management in the South Asian countries, especially regarding limited exposure to short-term foreign debt because of prudent capital account controls. Thus the effort launched over the past few years in all the South Asian countries to reduce the extent of nonperforming loans is a wise move. Progress is encouraging and the share of nonperforming loans is falling, but the countries still have a long way to go. The problem cannot simply be resolved by strengthening prudential regulations, which so far has been the main focus of policy in all the South Asian countries except Pakistan.⁹ Ownership matters, and the long-term solution to ensuring a stable and efficient banking sector is to establish a competitive banking sector run by private enterprises and prudently regulated by the central bank (Ahmed, Ramachandran, and Uy 2003).



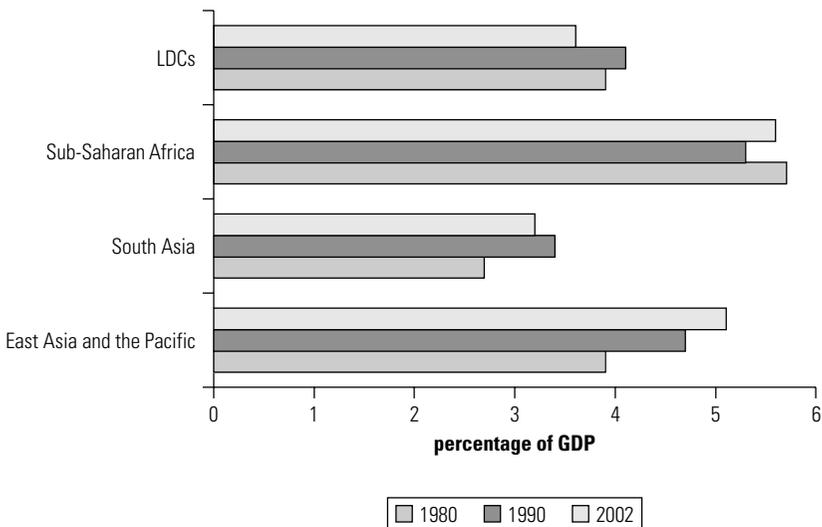
4 **Policies for Improving Human Development**

We saw in chapter 2 that South Asia has made impressive progress with human development, but that this progress varies by country and that indicators lag significantly behind those of countries in East Asia and the Pacific. What factors have made this progress possible and how should policy change to help South Asia move forward? It is universally acknowledged that budgetary spending could have a determining influence on improving human development, especially in low-income economies. The level and quality of public spending on such activities as education, health, and water supply can make a huge difference in influencing the well-being of citizens, especially the poor. The important point to note is that both the level and the quality of spending are important.

PUBLIC SPENDING ON HUMAN DEVELOPMENT

Figure 4.1 shows public spending on human development in South Asia relative to that in other regions. As a share of GDP, public spending grew during 1980–2002 over its low levels in the 1970s; however, the level of public spending in the South Asian countries is significantly lower than that in other regions. In addition, while the share of public spending in the 1980s increased from its level in the 1970s, this progress was halted in the 1990s. Overall, the low level of public spending on human development is an important failure of public policy in South Asia.

If public spending is substantially lower than in other regions and exhibits slow growth as a share of GDP, what explains the large improvement in human development in South Asia over the past two decades? First, the increase in public spending during 1980–2002 did help. Second, a part of the answer lies in the growing share of private spending on human development in South Asia; third, to a large extent it also reflects some important qualitative strengths in relation to focusing public spending on the right areas. For example, in health, much of the gain in life expectancy and infant mortality came from



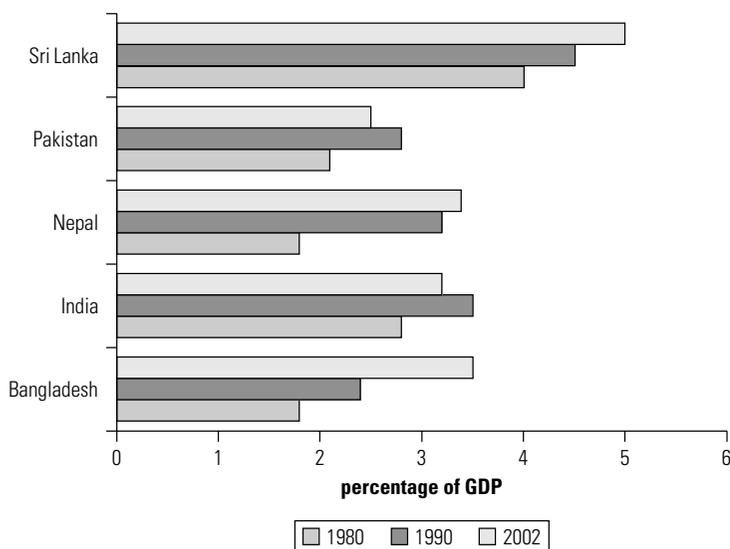
Source: World Bank various years.

Figure 4.1 Public Spending on Human Development, Selected Regions and Years

reliance on low-cost preventive and curative measures. To the credit of South Asian policy makers, health spending focused to a substantial extent on the prevention of mass communicable diseases such as cholera, malaria, smallpox, and tuberculosis. Similarly, the discovery of simple solutions, such as the famous saline treatment for cholera developed in Bangladesh, helped prevent the death of infants from cholera with little expenditure. In contrast, the high incidence of HIV/AIDS in Sub-Saharan Africa took a substantial toll despite the much larger GDP share of public spending on health. A fourth factor is the increasing reliance in the South Asian countries on public-private partnerships in the delivery of human development services. Bangladesh has pioneered this approach, with the result that world-class nongovernmental organizations (NGOs) such as Bangladesh Rural Advancement Committee (BRAC) have succeeded in developing low-cost education delivery. The reduction in fertility rates has similarly benefited from this type of partnership.

While these gains should be celebrated, comparable low-cost options are clearly not available for further improvement in human development. For example, in the area of health, many of the benefits of controlling mass communicable diseases on a large scale seem to have been exhausted, and the focus of attention will likely need to shift to pockets of hard to reach areas and communities and to the prevention of more complex diseases such as HIV/AIDS. The quality of the average public health service is low, which requires major attention. In the area of education, attention needs to shift to improving quality and public service delivery, learning from the lessons of relevant NGO experiences. These demonstrate the need for higher levels of spending along with efforts to improve public service delivery.

As noted in chapter 2, the priority attached to human development varies significantly among the South Asian countries. Historically, Sri Lanka has taken the lead in pushing the human development agenda, followed by Bangladesh, India, and Nepal. Pakistan has been a laggard. One reflection of this is the level of public spending on human development by each of the countries (figure 4.2). Compared with 5 percent of GDP devoted to human development in Sri Lanka in 2002 (which used to spend even more in the 1960s and 1970s), Pakistan spent less than 3 percent, with the other countries falling in between. With the exception of Sri Lanka, other South Asian countries have generally



Source: Data from ministries of finance.

Figure 4.2 Spending on Human Development, South Asian Countries, Selected Years

Table 4.1 Public Spending Priorities, South Asian Countries, 2002
(percentage of GDP)

Country	Revenue	Interest costs	Human development	Defense
Bangladesh	10.4	1.9	3.5	1.5
India	18.4	6.5	3.3	2.3
Nepal	11.2	1.9	3.4	1.4
Pakistan	14.5	7.0	2.5	5.0
Sri Lanka	18.0	6.0	5.0	5.0

Source: Data from ministries of finance.

been less forthcoming than countries in East Asia and the Pacific in devoting public resources to human development. As table 4.1 shows, this is partly due to generally weak public resource mobilization (Bangladesh and Nepal) or to lower relative expenditure priorities (India and Pakistan). In the case of India, interest costs have occupied much more fiscal space than human development. In Pakistan, interest costs and defense spending have crowded out spending on human

development. Overall, Sri Lanka's human development spending is comparable with that in East Asian and Pacific countries and the other South Asian countries need to catch up to these levels. The challenge is most intense for Pakistan, which also has the most catching up to do in relation to human development indicators.

THE SERVICE DELIVERY CHALLENGE

We have seen that with the exception of Pakistan, the South Asian countries have, on average, been able to secure fairly impressive progress with human development despite limited public spending. What specific policies contributed to these achievements?

Sri Lanka

In the case of Sri Lanka, public spending levels were the primary driver of progress with human development. Even long before its independence in 1948, Sri Lanka had a tradition of commitment to social development (Abeysekera 1986). This became the central focus of development strategy after independence and has remained intact, even though the ethnic conflict that started in the 1980s has taken a huge toll. Sri Lanka has relied primarily on public sector service delivery, with a limited role for the private sector. While the outcomes for human development are impressive and Sri Lanka has already met or exceeded most relevant Millennium Development Goal targets, there are concerns about the quality of human development in regard to relevance to the job market (World Bank 2004f). The quality of education in terms of its relevance is a particularly important issue, given the importance of education for accelerating growth. There are also concerns about Sri Lanka's readiness to address the human development challenges related to the demographic transition that has set in in Sri Lanka, for example, the challenges related to providing health care for a growing elderly population. Finally, malnutrition among children surprisingly remains a major issue in Sri Lanka.

Bangladesh

The case of Bangladesh is a striking example of how major improvements in human development are possible even with limited resources. While public spending on education increased during

1980–2002, a major factor underlying Bangladesh's rapid progress with human development is its better effectiveness of spending. A number of policies made this possible. First and foremost is the strong partnership that Bangladesh developed between the public and private sectors in the delivery of family planning, basic health, and basic education services (Ahmed 2005; World Bank 2003a). In this model, public financing was deployed to NGOs to deliver these services. The NGOs ensured that the delivery cost was low and that beneficiary participation was high. Also by reducing corruption, the bulk of the benefits were channeled to the intended groups.¹⁰

Second, Bangladesh focused its limited public resources on areas that had the maximum impact on health outcomes (World Bank 2003a). Thus national health policy emphasized primary health care in rural areas, population control, and immunization, which were indeed the most pressing needs in postindependence Bangladesh.

Third, the government's focus on eliminating the urban-rural and gender gaps in education paid off. The success with eliminating the gender gap is particularly impressive. A major policy that contributed to this is the female education stipend program (World Bank 2003a).

Despite these achievements, major challenges remain. These include ensuring the quality of education and health; addressing the problem of child malnutrition more comprehensively; resolving the problem of arsenic contamination of water, which poses a serious health risk; and reducing air and water pollution resulting from poor waste management. A major institutional challenge is the reform of public service delivery, where the policy agenda is substantial (World Bank 2003a). Concerns include the low quality of the civil service, the large incidence of corruption associated with service delivery, and a centralized system of service delivery necessitated by the absence of an effective system of local government.

India

After long years of neglect, India's focus on human development has gained momentum since the 1980s (for an excellent discussion of the politics of human development in India, see Dreze and Sen 2002). This resulted in a significant expansion of public spending on education, although health spending remained low. Much of the initial push came from state governments.

The budgetary crunch of the 1990s caused a significant slowdown in state spending on education, although the central government chipped in with a bigger pot provided through centrally sponsored schemes. While centrally sponsored schemes have been helpful in pushing the education agenda, state leadership has made the difference; however, progress has been highly uneven among the states (World Bank 2004a). Leaders like Haryana, Himachal Pradesh, Kerala, Maharashtra, and Tamil Nadu have exerted the political weight to support human development and have achieved good outcomes. At the same time, laggards like Bihar, Orissa, and Uttar Pradesh have low human development attainments. Much of the difference in educational outcomes is due to differences in political support and associated governance issues related to service delivery. In states like Haryana, Himachal Pradesh, Kerala, Maharashtra, and Tamil Nadu, the combination of state leadership and community awareness and involvement have maintained the social and political momentum for pushing for progress with improving educational outcomes. These states have also made good progress in reducing gender disparities. The relatively homogeneous social setup of these states helped considerably. In the lagging states of Bihar, Orissa, and Uttar Pradesh, a combination of low political commitment, weak social cohesion, and low community involvement has persisted in reducing the effectiveness of public spending in improving education outcomes. Not surprisingly, gender disparities are also substantial in these states.

A general problem facing India is the low quality of service delivery for public education. The problems include low nonsalary resources that limit schools' ability to provide education materials and supplies, teacher absenteeism, high student dropout rates, and low education attainments (World Bank 2003c, 2004a). In health, public spending has remained relatively low as a percentage of GDP (less than 1 percent), and much of the spending on health care has come from the private sector (World Bank 2003c). Nevertheless, much of the public spending was focused on the prevention of mass communicable diseases (polio, tuberculosis, and malaria), resulting in good health outcomes from this small level of spending. While this has been a positive policy step, attention to HIV/AIDS has not been as forthcoming, and unless tackled with determination, its adverse effects on human development could be severe. The implications for increased

public spending to achieve better health care and also address the HIV/AIDS issue are substantial.

Nepal

Education spending in Nepal has emphasized primary and secondary education. Along with an overall increase in education spending, this emphasis has supported the expansion of access to schooling. However, quality problems are serious (World Bank 2004e). These reflect low levels of resources for teaching materials and supplies, low teacher quality, and weak accountability of schools because of weak oversight arrangements. The upturn in the Maoist insurgency has added to the problem by disrupting service delivery. Recently, partly in response to the insurgency and partly to increase the accountability and effectiveness of public spending, greater responsibility is being devolved to communities, especially in rural and remote areas. Micro evidence suggests that schools in such communities have higher effectiveness in service delivery compared with public schools. Progress on basic health has been more limited, partly because of low public spending, but also because of weakness in service delivery. The geography of Nepal is another constraint. Delivering basic health services to women and children in remote areas is a major challenge given Nepal's poor infrastructure.

Pakistan

In sharp contrast to Bangladesh, the example of Pakistan is a textbook case of how adverse social and political factors can constrain human development. While spending on education and health has been low, a much bigger problem has been poor service delivery resulting from weak governance (Ahmed 2002a, 2002b; World Bank 2002a). As in the case of the state of Bihar in India, the adverse social and political environment has hurt the cause of education. Even though public spending expanded in the 1990s because of donor pressure, the effectiveness of this spending did not. Heavily centralized public delivery with poor accountability and oversight resulted in significant corruption and waste. More recently, Pakistan has attempted to devolve responsibility for education delivery to local governments (for a detailed review of Pakistan's devolution efforts, see World Bank, Asian Development Bank, and Department for International Development

2004). Progress to date has been uneven, with concrete evidence of good results emerging only from Punjab. The outcomes in health are somewhat better because, like other South Asian countries, much of the spending has been concentrated on mass communicable diseases. However, unlike Bangladesh, Pakistan did not rely as much on partnerships with NGOs and communities, thereby exposing public spending to a higher incidence of corruption and inefficiency.

Summary of experience with service delivery

Two key messages emerge from South Asia's experience with service delivery. First, public service delivery is weak and suffers from serious corruption problems in all the South Asian countries. This is partly the result of heavily centralized service delivery, but also reflects poor quality, lack of incentives, and low accountability of public providers. The experience with service delivery thus exposes a major weakness in the South Asian countries: the inadequacy of public institutions. Second, Bangladesh and some of India's states have sought to bypass the weakness of public service delivery by entering into partnerships with NGOs. This model of public funding and private delivery has yielded positive results.



5 Progress with Public Sector Reforms

People who see the experience of South Asia as a development puzzle are focusing on the perception of a weak and corrupt public sector, including political parties, as reflected in the perception-based ratings of various agencies, especially by Transparency International (see Kaufmann, Kraay, and Mastruzzi 2005 for a summary of these ratings). Some of the related agenda is political in terms of system of governance, political accountability, campaign finances, and human rights. The other part is directly relevant to the growth of the economy and to the sustainability of reforms. These include

- management of the budget
- anticorruption policies and institutions
- independent regulatory bodies to protect public interests
- decentralization and devolution of decision making
- civil service reforms.

The institutional arrangements underlying each of these themes and associated issues are interrelated. Nevertheless, focusing on each of these important themes separately is helpful to clarify underlying issues, measure specific areas of progress, and identify areas that require further attention.

MANAGEMENT OF THE BUDGET

The government budget is probably among the most fundamental institutions that has a determining influence on development performance (Ahmed 2004). In several respects, management of the budget has been a positive factor in Bangladesh, India, Nepal, and Sri Lanka. First, the emphasis placed on human development in budgetary allocations is a substantial achievement. This has been a problem in Pakistan, although it has recently taken some corrective action. Second, some progress has also been made in improving the tax structure. For example, all the South Asian countries have sharply reduced their reliance on trade taxes for revenues. Efforts are also under way to enhance reliance on broadly based taxes such as the value added tax. Thus Bangladesh has already introduced a value added tax. Nepal, Pakistan, and Sri Lanka have made progress in relation to this transition, while India is at the preparatory stage. Third, a number of South Asian countries (Nepal, Pakistan, and Sri Lanka) and Indian states (Andhra Pradesh, Karnataka, and Orissa) aim to move gradually toward a medium-term expenditure framework. Progress is most advanced in Nepal and the three Indian states. Fourth, some South Asian countries (India and Pakistan) and Indian states (Andhra Pradesh and Karnataka) have also introduced legislation to induce fiscal discipline. Nevertheless, budgetary management has not progressed adequately in a number of areas. One key problem is tax administration. Overall tax efforts are weak because of both low coverage and low tax compliance. Modernization of the tax administration is a major institutional challenge for all the South Asian countries. In addition to contributing to low tax collection, poor tax administration has been a major source of corruption and, as noted in chapter 3, is of concern to private investors.

The budgetary process in the South Asian countries continues to suffer from a number of weaknesses that reduce the effectiveness of

the budget. These include the lack of a strategic focus and of clarity on sectoral priorities; the inadequacy of information on the costs of policies, programs, and services; the short-term horizon for budget decision making that fails to account for long-term costs and benefits; an artificial separation of development and recurrent budgets that weakens the integrated, strategic content of the budget; and the end of year spending incentives that reduce the efficiency of spending. These drawbacks have often led to inefficient spending decisions. For example, the separation of development and recurrent spending has resulted in inadequate attention being paid to the recurrent cost implications of capital spending. Indeed, operation and maintenance has typically tended to be neglected, causing low returns from capital spending. The lack of good costing analysis for public programs and policies has similarly meant that many programs are inappropriately or inadequately funded, leading to poor efficiency of these programs. Many public programs are based on political expediency rather than on careful analysis and choices made among competing priorities, contributing to low returns from such spending.

Improving budget formulation to link policy planning and budgeting is necessary for the countries to embark on such strategic planning initiatives as the Poverty Reduction Strategy. While initial progress with the implementation of a medium-term expenditure program has occurred as noted earlier, there is still a long way to go to make this process fully effective. The issues that need more effort and resolution include assigning clear responsibilities between different levels of government and different line ministries, developing capacity to undertake detailed costing of programs and policies, establishing sectoral and program priorities, setting realistic program goals and targets, and strengthening the relationship between the Poverty Reduction Strategy and annual budgets.

Another key factor constraining the effectiveness of public expenditure in the South Asian countries is weak expenditure monitoring and evaluation systems. The traditional monitoring emphasis has been on the spending of budgetary allocations rather than on outcomes. Thus the success of budget implementation is judged on the basis of how closely actual spending matched the allocated budget. The tracking of expenditure has also been constrained by inadequate attention paid to data quality and timeliness. As part of the Poverty

Reduction Strategy, efforts are now under way in Bangladesh, Nepal, and Pakistan, and the Indian states Andhra Pradesh, Karnataka, and Orissa to establish a mechanism for monitoring poverty-related expenditures, along with their intermediate indicators and outcomes, in relation to the specific human development and poverty targets in the Poverty Reduction Strategy. When fully functional, such a mechanism can provide a powerful analytical tool for assessing the effectiveness of public spending in achieving stated outcomes. Its success, however, requires a long-term effort to increase monitoring and evaluation capacity and strengthen the underlying database in terms of its quality, comprehensiveness, and timeliness.

Soundness of the financial accountability system has been a fundamental institutional constraint on public spending in all the South Asian countries. This concern is one reason for the high perceptions of corruption. Major issues include the following:

- *Ineffective parliamentary and executive control of budgetary spending.* Audit reports on annual accounts often tend to be heavily qualified, and accounts do not meet the expectations of countries' constitutions and associated laws and regulations. Similarly, legislative oversight of the accountability system is weak. The accountability of the executive branch of government is often not sufficiently supported by information that would enable it to focus on results and outcomes.
- *Separation of audits and accounts.* The separation of audits and accounts took a long time to achieve, and in some cases, the process has yet to be completed.
- *Penalties.* Even though a system of penalties exists, these sanctions and their implementation are inordinately cumbersome and time consuming.
- *Audit quality.* The quality of audits suffers both from quality problems and lack of timeliness of data, as well as from the lack of automation and low staffing quality.

To address these concerns, all the South Asian countries have recently introduced reforms to strengthen financial management and accountability. Financial accountability assessments have been done for all the countries, and reform programs have been developed based on these assessments. Implementation is now under way. The reforms are long term and will require sustained efforts.

ANTICORRUPTION POLICIES AND INSTITUTIONS

The South Asian countries continue to be ranked poorly on corruption by Transparency International. While one can debate the precision of the rankings and the associated methodology, corruption is clearly a major development constraint. The associated high cost of doing business resulting from corruption has an adverse effect on the investment climate (table 3.6). The missed opportunities for higher levels of investment and growth can be substantial.

The enormity of the corruption problem is recognized by all the South Asian countries, and a strategy is evolving in each country to tackle many of the problems at source. The strategy involves efforts at both the economywide level and at the sectoral level. At the aggregate level, efforts are being made to improve procurement policies; financial management policies; sharing of and access to information; and budget management, including tax administration, along with establishing special watchdog institutions to fight corruption, such as the Anticorruption Commission in Bangladesh, the Commission for Investigation of Abuse in Nepal, and the National Accountability Bureau in Pakistan. At the sectoral level, the focus is on deregulating to reduce the scope for public intervention in commercial decision making; reducing public ownership in commercial activities; and introducing better regulatory policies and oversight in banking, energy, and infrastructure. These efforts are yielding results in a number of areas in terms of better management of public expenditures, reduced levels of nonperforming loans of banks, and higher collection of utility bills. This progress is encouraging, but the countries still have a long way to go. The implementation of many of the sectoral reforms has begun only recently, while the implementation of some economywide initiatives, such as the anticorruption commissions, tends to become mired in political jockeying, demonstrating the highly political nature of these reforms. Thus sustained political will at the highest levels is essential for success in the long term.

INDEPENDENT REGULATORY BODIES TO PROTECT PUBLIC INTERESTS

The corruption problems emanate partly from the absence of proper regulatory bodies, which reduces the accountability of concerned public and private agencies. Important examples of these regulatory

institutions are independent central banks, autonomous tax administrations, independent audit bodies, public accounts committees, and utility regulatory bodies. The advantage of these institutions is illustrated by the recent progress in the banking sector in Bangladesh and Pakistan. To a significant extent, the progress with banking reforms in Bangladesh has been possible because of the recent empowerment of the central bank to regulate the banking sector more rigorously without excessive interference from the government. The experience of Pakistan's banking sector with this approach is similarly illustrative of the good outcomes that strong institutions can deliver. Similarly, the separation of audits from accounts and the establishment of an autonomous audits unit is yielding good results in Pakistan. The public accounts committees are also starting to work in both Bangladesh and Pakistan and hold promise for good outcomes. This progress is, however, small and gradual. The agenda is long and arduous, thus once again strong, sustained political will is necessary.

DECENTRALIZATION AND DEVOLUTION OF DECISION MAKING

South Asia has two large countries with a federal form of government, while the others are all unitary. Of the two large federations, India is much more decentralized in terms of economic decision making than Pakistan. India's states have considerable economic and financial powers compared with Pakistan's provinces. The revenue-sharing arrangement between the states and the federal government in India is also more systematic and predictable than between the provinces and the federal government in Pakistan. Thus with the exception of India, public administration and decision making in the South Asian countries tend to be heavily centralized in the capital cities of each country. In each of these countries, almost all authority is exercised by the head of the government and the cabinet. Local governments are weak, with little administrative and financial authority. A number of attempts have been made to establish stronger systems of local government, but these have had limited success because of the lack of strong political commitment at the top. Consequently, the setting of expenditure priorities, the allocation of resources, the procurement of goods and services, and the implementation of projects are largely

centralized at the ministry level in the capital city. District administrations are run by civil servants with little independent authority. Thus local-level involvement is limited to running public facilities at the district level and maintaining law and order. In addition, local-level civil servants are not accountable to local governments but to ministries at the central level.

Political progress on decentralization has suffered from an unsupportive attitude on the part of the large political parties, despite supportive rhetoric. At the heart of the debate is the contentious issue of the division of power between national and provincial legislators and local governments. National legislators have tended to argue that they can take care of their constituencies without the need for intermediary political agents, namely, elected and empowered local governments. Civil servants have also found the current situation convenient, because it has given them more authority without accountability than they would otherwise have, especially at the local level.

What has been the outcome of this heavily centralized administration for development performance? Even though the jury is out on the international evidence on the role of decentralized governments in service delivery (World Bank 2003d), one can argue that the centralized systems of public service delivery are likely to be important contributors to the poor service quality in Bangladesh, Nepal, Pakistan, and Sri Lanka and need to be revisited. In the case of Bangladesh, this is perhaps best illustrated by the positive experience with the delivery of basic social services (education, health, and water supply) through NGOs, which tend to work closely with local communities, compared with delivery by centralized public services with poor accountability. It is generally acknowledged that, on average, health and education services delivered by NGOs and involving community participation have been significantly better than comparable services provided by public facilities (see, for example, Ahmed and Nath [2004] for a review of BRAC's experience in delivering primary education). This is not surprising. NGOs' facilities have typically involved heavy participation by local community members in the design and delivery of services and better accountability by NGO officials, whereas public services generally suffer from a lack of community participation and accountability of service providers. Centralized management has meant the absence of any functioning mechanism

to ensure the accountability of local public service providers. Thus, for example, teachers or health workers continue to be paid whether or not they show up for work, because they are not hired by the community and are not punished for nonperformance. In Sri Lanka, the centralized system of administration has contributed to the large disparity in the distribution of basic services (World Bank 2004f).

In India, local governments are relatively more advanced, but performance by states and within states is uneven. The local governments, known as *panchayati raj* institutions, are established by the state governments. In many states, such as Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, and West Bengal, the *panchayati raj* institutions are generally quite effective and have done a reasonably good job of delivering assigned services. The record in other states is less compelling. In all the states, the *panchayati raj* institutions' role could be substantially strengthened, but on the whole, India's commitment to local governments has been stronger than that of other countries in the region.

Recently, Pakistan has initiated an ambitious devolution program to establish elected local governments and give them greater responsibility for delivering basic services, including health and education. A detailed review shows that while this initiative has good potential for improving service delivery, several political and administrative challenges remain to be addressed (World Bank, Asian Development Bank, and Department for International Development 2004). In particular, fiscal devolution has yet to take place. In addition, serious conflicts have emerged in provinces where local governments are not aligned with the political parties of the provincial governments. So the reforms, while bold and promising, are still evolving.

CIVIL SERVICE REFORMS

In all the South Asian countries, civil servants are responsible for day-to-day general administration. This system was inherited from British colonial times and has changed little in terms of basic attitudes and accountabilities. In the early days following the independence of India and Pakistan from the British, the standards for selecting civil servants were tough, leading to high-quality officers. The high quality of the

officers and the prestige value of the job sometimes motivated them to take a missionary stance and make efforts to contribute to local development. Over time, however, the quality of the civil service has weakened in most South Asian countries. Their pay and benefits have also fallen drastically in real terms in most of the countries except India.

Reviews of the state of civil service performance by country reveal a common pattern (World Bank 1998, 2002c, 2003c). First, while the overall size of the civil service in relation to the total workforce or size of the country is not large, a huge imbalance exists in its composition, with a heavy tilt toward class III and class IV employees. For example, in India, class III and class IV employees are estimated to account for as much as 93 percent of the staff of federal and state governments (World Bank 2003c). These employees generally tend to be low-skill and low-value added staff, but with tremendous political power in terms of their impact on electoral outcomes. Second, public administration tends to be fragmented, with too many ministries and departments, and interdepartmental coordination is a major problem. Third, the quality and effectiveness of civil servants vary considerably by department, level of government, and country. Fourth, the assignment of civil servants to senior positions is determined by political factors rather than by merit. This also results in frequent transfers of key staff, which has an adverse effect on development activities. Finally, except for India, civil servants' pay and benefits are generally considered inadequate, reducing their quality at entry as well as contributing to corrupt practices.

Reform efforts in this area have been weak. Many commissions have been established in different countries to try to reform the civil service. In most cases, the recommendations in the resulting reports were sound and sensible, but few have been implemented. The main reason for the lack of action in this area is the absence of political will and the intransigence of vested interests, particularly the class III and class IV employees. The inability to address the problem of the preponderance of this group of staff has prevented reforms in other areas, particularly pay and benefits. Nevertheless, even though a systematic reform effort has not been possible, some partial reforms have taken place. All the countries and the Indian states have put restraints on new recruitment, especially at the class III and IV levels. Some of the

Indian states have also introduced measures to reduce frequent transfers of key staff. Efforts are also ongoing in different countries to improve civil service quality through merit-based promotions and training.

Clearly large-scale civil service reform lacks a political champion in the South Asian countries, which is unfortunate. Given this reality, reforms have to be gradual and incremental. Further deregulation and reduction of the public sector's role in delivering commercial services will also help. Similarly, greater devolution of responsibilities to publicly elected local bodies will help create an enabling environment for civil service reforms. The agenda is a long-term one and progress is likely to be gradual.

CONCLUSION

The review of the record of public sector reforms in South Asia indicates a mixed picture. Progress has been made or recently initiated in some areas, but a significant agenda remains. The fact that the South Asian countries have made good progress with development despite weak institutions is not really a puzzle, because this characterization ignores the effects of a large number of good policies that have prevailed despite overall weak institutions. The ability to maintain sound macroeconomic management, gradually opening up the economy to international trade and competition, reforming the banking sector, and putting money into human development have all played important roles in this development outcome. Reforms, either of policies or of institutions, are essentially political in nature. While in a textbook environment we can have a neat sequence of reforms with the highest priority devoted to developing this institution or that, in practice, priorities will emerge from a political consensus. Thus the balance of progress with policies and institutions in the South Asian countries emerged essentially from the political environment.

The practical challenge facing policy makers is aptly described as follows by Ahluwalia (2002a, pp. 86–87) based on his experience with India:

Critics often blame the delays in implementation and failure to act in certain areas to the choice of gradualism as a strategy. However, gradualism implies a clear definition of the goal and a

deliberate choice of extending the time taken to reach it, to ease the pain of transition. This is not what happened in all areas. The goals were often indicated only as a broad direction, with the precise end point and the pace of transition left unstated to minimize opposition—and possibly also to allow room to retreat, if necessary. This reduced politically divisive controversy and enabled a consensus of sorts to evolve, but it also meant that the consensus at each point represented a compromise, with many interested groups joining only because they believed that reforms would not go “too far.” The result was a process of change that was not so much gradualist as fitful and opportunistic. Progress was made as and when politically feasible, but since the end point was not always clearly indicated, many participants were unclear about how much change would have to be accepted, and this may have led to less adjustment than was otherwise feasible. The alternative would have been to have a more thorough debate with the objective of bringing about a clearer realization on the part of all concerned of the full extent of change needed, thereby permitting more purposeful implementation. However, it is difficult to say whether this approach would indeed have yielded better results, or whether it would have created gridlock in India’s highly pluralist democracy. Instead, India witnessed a halting process of change in which political parties that opposed particular reforms when in opposition actually pushed them forward when in office. The process can be aptly described as creating a strong consensus for weak reforms.



6 Addressing the Challenge of Growing Inequality

The impact of growth on poverty is affected by income distribution and could be reduced by an increase in income inequality (see, for example, Ravallion 2005). Evidence of growing income inequality has been found in China and in India and other South Asian countries. Is income inequality an inevitable consequence of growth? This chapter looks at this issue.

RELATIONSHIP BETWEEN GROWTH AND INCOME INEQUALITY

The relationship between growth and inequality has been studied at length (for a good summary of the literature, see Aghion, Caroli, and Garcia-Penalosa 1999). The seminal empirical research on this relationship was done by Kuznets (1955). He found the following relationship between per capita GNP and income inequality: during the early stages of development (low per capita GNP), income inequality is low, but it

then tends to increase with higher growth; as development proceeds, this rising inequality is arrested and is eventually reversed at higher levels of per capita GNP. Kuznets rationalized this result by arguing that during the early stages of development, a typical low-income economy is characterized by heavy domination by agricultural and rural low-income activities. As development proceeds, a move occurs from an agro-rural economic base to an urban-industrial economic environment where income tends to be higher because of higher value added activities. Eventually, more and more people transfer to the urban-industrial economy, thereby tending to equalize incomes. This inverted U-shaped curve relationship between inequality and per capita GNP, known as the Kuznets' hypothesis, dominated the literature for some time.

Many researchers sought to test this hypothesis with increasing sophistication and better data. The evidence casts doubt on the general validity of the hypothesis, that is, that income inequality is a necessary consequence of higher growth in low-income economies. Indeed, evidence indicates that policies that reduce inequality could also contribute to higher growth (Aghion, Caroli, and Garcia-Penalosa 1999; Ravallion 2005; World Bank 2005a). Policies that may be helpful for both growth and lower inequality include interventions to correct distortions in financial markets, redistribution through public expenditure policies and programs, policies and programs for rural development, and safety net programs. The debate has therefore shifted to finding out how to make growth more pro-poor (Bourguignon 2002; Ravallion 2001, 2005; World Bank 2005a).

EXPERIENCES IN SOUTH ASIA

What is the experience with inequality in South Asia and how does this compare internationally?

Evidence of inequality

Table 6.1 presents data on income distribution for the four largest South Asian countries. The numbers are mostly for distribution of consumption and have been obtained from a variety of sources. Despite this risk of incomparability, a major conclusion that can be drawn from these numbers is that evidence exists of a worsening trend for income distribution in all four South Asian countries, especially during 1990–2000. This implies that the effectiveness of the

Table 6.1 **Distribution of Income or Consumption, Selected South Asian Countries and Years**
(*Gini coefficients*)

Country	1970			1980			1990			2000		
	National	Rural	Urban									
Bangladesh	—	—	—	0.26	0.24	0.29	0.27	0.24	0.31	0.31	0.27	0.37
India	0.30	0.29	0.35	0.31	0.30	0.34	0.30	0.28	0.31	0.33	0.30	0.35
Pakistan	—	—	—	0.28	0.26	0.31	0.29	0.27	0.32	0.30	0.25	0.35
Sri Lanka	—	—	—	—	—	—	0.32	0.29	0.37	0.40	0.39	0.42

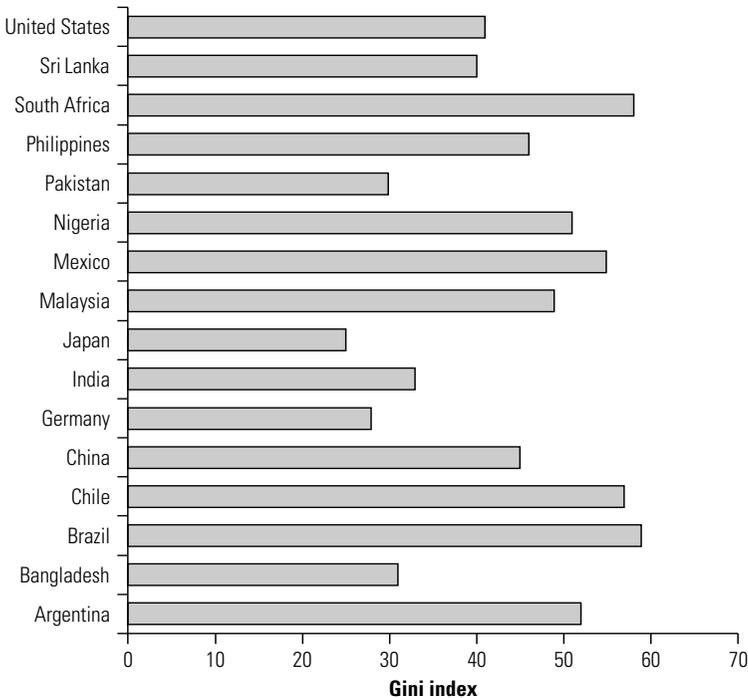
Source: Bangladesh: Ahmed 2002a; India: Datt 1997; Deaton and Kozel 2005; Pakistan: World Bank 2002a; Sri Lanka: Ahmed 2002a, Narayan and Yoshida 2005.

— = Not available.

rapid growth of per capita GDP in lowering poverty in this period was reduced by a worsening of income inequality. Addressing this concern presents another major policy challenge.

Inequality of South Asia in the international context

Before we look into the inequality issue in more depth, comparing income distribution in the South Asian countries with that in other countries is useful. This is done in figure 6.1 for selected countries and indicates wide variation in income inequality among countries. In countries of the Organisation for Economic Co-operation and Development, the Gini coefficient ranges from a low of 0.25 for Japan to a high of 0.41 for the United States. Among the East Asian and Pacific countries, the Gini ranges from a low of 0.30 for Mongolia to a high of 0.49 for Malaysia. In Sub-Saharan Africa, the Gini ranges from 0.30 for Ethiopia to 0.71 for Namibia. In Latin America and the Caribbean, the range extends from 0.44 for Ecuador to 0.59 for Brazil.



Source: World Bank 2005e.

Note: Data are for different years for different countries.

Figure 6.1 Income Inequality, Selected Countries

In South Asia, the range is from 0.30 for Pakistan to 0.40 for Sri Lanka.¹¹ What this comparison shows is that countries in the South Asia region are, on average, still more equal than those in other regions, where income inequality tends to be more pronounced. In particular, the Gini coefficients for the three large countries of India, Bangladesh, and Pakistan are in the range of 0.30–0.33, which compares favorably with most other large countries. While this does not negate the need for addressing the inequality problem in the South Asian countries, knowledge that the depth of the policy challenge is much more manageable is comforting.

EXPLAINING INEQUALITY IN SOUTH ASIA

What are the characteristics of the increase in inequality in the South Asian countries? This subject has been studied at length in a number of recent studies for Bangladesh (World Bank 2002b), India (Deaton and Kozel 2005), Pakistan (World Bank 2002a), and Sri Lanka (Narayan and Yoshida 2005).

- In the case of Bangladesh, the rise in inequality resulted from three factors: first, rural inequality increased; second, urban inequality increased even faster; and third, the gap between mean consumption of urban and rural areas also grew.
- In India, the rise in inequality has taken several forms. First, per capita consumption by states has diverged, with consumption in the richer states growing faster than the poorer states. Second, inequality has increased in urban areas. Third, the gap between average urban and rural per capita consumption has also risen.
- In Pakistan, the inequality occurred largely because of the increase in urban inequality, but the gap between urban and rural average consumption also grew.
- Finally, in Sri Lanka the increase in inequality is partly a reflection of huge regional disparities, especially the dominance of Colombo and the Western Province in generating the bulk of the country's income, and the inequality in incomes within urban areas.

Solid empirical research into what factors have contributed to these rising inequalities is not available, although partial analysis suggests several common factors.

- First, urban incomes have grown, on average, much more rapidly than rural incomes in all the South Asian economies. This is partly

a reflection of the focus of reforms on activities that are predominantly urban based. Indeed, reforms affecting rural economies have generally lagged.

- Second, the distribution of wealth, especially physical assets such as land, is believed to be much more unequal than income or consumption. This has given an extra advantage to owners of these assets in that they can benefit from more income-earning opportunities.
- Third, progress with financial reforms, especially for the rural sector, has lagged behind other reforms, again causing access problems and rent-seeking behavior that has contributed to greater inequality.
- Fourth, the distribution of public services such as health, education, and infrastructure has been uneven across areas, leading to better income-earning opportunities for the better-off areas. Rural areas in general have poorer access to these services relative to urban areas in all the South Asian countries.
- Finally, the issue of lagging regions remains a major challenge. While this is most obvious for the large federations of India and Pakistan, regional issues are also apparent in the unitary states of Bangladesh, Nepal, and Sri Lanka.

These suggest that despite past progress, the agenda for reforms in South Asia remains substantial.

THE WAY FORWARD

The observed increase in inequality and regional disparity in the South Asian countries is a serious concern that will need to be tackled. As noted earlier, inequality is not a necessary consequence of higher growth, but a reflection of inadequate public policy response. What specific interventions could be of help? First, policy reforms to reduce rent-seeking opportunities and improve access by the poor to finance and investment will be important. Second, institutional reforms related to a better investment climate and to human development will also help address the inequality problem. Third, budget spending to improve income-earning opportunities in lagging regions will promote equality of opportunities. Fourth, improving the functioning of land markets to reduce transaction costs will promote wider ownership of land. Finally, legal reforms that improve access by the poor to judicial support to speedily resolve disputes and protect them from exploitative behavior could be of assistance.



7 **Future Reform Priorities**

The evidence is clear that South Asia has performed well over the past 20 to 25 years when compared with the rest of the developing world except East Asia and the Pacific. The impetus for change came in the 1980s, but economic growth and progress with reforms accelerated in the 1990s. Many have been puzzled by this outcome because of the perception that the South Asian countries have serious governance problems reflected in political instability, weak law and order, government ineffectiveness, and corruption.

This paper argues that South Asia's development performance is not a puzzle, but is largely explained by good policies. Thus the South Asian countries have maintained good macroeconomic environments; opened up their economies to greater domestic and international competition; and reduced the role of corrupt and inefficient public enterprises, which have mostly been a drag on the economy. These policies have improved investors' incentives and supported increases

in private investment, exports, and incomes. At the same time, attention has been paid to improving human development through public spending. This spending, although low relative to needs, has focused on priority areas, including expanding primary and secondary education, educating girls, controlling population size, and eradicating mass communicable diseases. The return to this investment has been substantial.

Many of these reforms also have implications for better governance and reduced corruption. Thus reforms in banking have substantially reduced the role of public sector banks that have been plagued with nonperforming loans largely because of corruption. Similarly, the privatization of public enterprises has plugged another hole that permitted political intervention and resource misuse. Reforms in public utilities have strengthened billing and collection efforts, which have reduced corruption from this source. Deregulation itself has substantially cut back the scope for rent-seeking behavior. The dismantling of the so-called license raj, including the removal of quantitative restrictions on trade, has led to substantially lower transaction costs for private businesses, which has been an important factor underlying the increase in private investment in the South Asian countries. Reforms in public spending have been slower, but recent efforts to improve financial management and procurement have tremendous potential for lower corruption in the long term. The positive effects brought about by these reforms may not have been picked up by perception-based governance indexes reflected in the work of Kaufmann, Kraay, and Mastruzzi (2005).

Notwithstanding this progress, the agenda for the future remains large. Because of its size, South Asia still has more poor people than any other region in the world. Human development indicators suggest the need for considerable further improvement, including the need to pay much more attention to the quality dimensions of human development. More rapid progress with poverty reduction will require a higher rate of growth. At around 6 percent per year, South Asia's growth performance is good, but it has the potential to grow at 7 to 8 percent. While progress with policy reforms has been good, progress with institutional reforms has been weak. Policy reforms must shift to addressing institutional concerns if this higher

potential is to be realized. This will also ensure the long-term sustainability of reforms and avoid the risk of reversals resulting from adverse political developments.

Continued attention to macroeconomic stability will be necessary. As experience shows, the focus on macroeconomic stability has served South Asia well, but vulnerabilities remain, especially because global integration implies not only the realization of benefits from access to world markets for goods and services, but also exposure to risks from global downside events. One example of this is the recent rise in oil prices, which has already imposed a substantial burden on the countries' balance of payments and fiscal management. Similarly, an increase in world interest rates or a downturn in world demand for South Asian exports could impose substantial costs. In this context, more attention needs to be given to fiscal management. The South Asian countries have tended to find it difficult to raise resources through a modern tax system. This has consequences for both revenue mobilization and improved governance. From an institutional perspective, the establishment of a modern tax system is among the countries' highest priorities.

Achieving a higher rate of growth will require further progress with improving the investment climate. The supply response from private investors to better incentives over the past 20 to 25 years is evidence that further reductions in the cost of doing business will be helpful in deepening capital formation in the South Asian countries. To this end, additional progress in three important areas will be critical.

- First, the availability of infrastructure (power, transport, and ports) is becoming a major constraint to private investment by significantly increasing the costs of doing business. The investment needs here are large and will require strong public-private partnerships. Fiscal reforms are also necessary to release resources for public investment in infrastructure. Commensurate with this, the effectiveness of public utilities, especially the power entities, must be strengthened—another priority area for institutional reforms. The utilities, whether public or private, must be run on commercial principles with prices reflecting market forces. The South Asian countries must understand that utilities cannot be run forever on the basis of price controls that are not related to the cost of supply.

In addition, continued reliance on public monopoly utilities will not provide supply efficiency. Competition is the only way to ensure efficiency of supply, and ways must be found to allow this. This will also improve consumers' willingness to pay based on choices for better service.

- Second, reductions in trade protection in the past have helped improve incentives. This should continue. Despite past progress, South Asia still remains heavily protected relative to other low-income economies. This is particularly true of Bangladesh and India.
- Third, progress with banking reforms, while encouraging, needs to be sustained, especially in relation to public banks, where reforms have been uneven. Except for Pakistan, public banks remain a concern for the overall health of the banking system. Reforms must be focused on preparing these banks for eventual privatization.

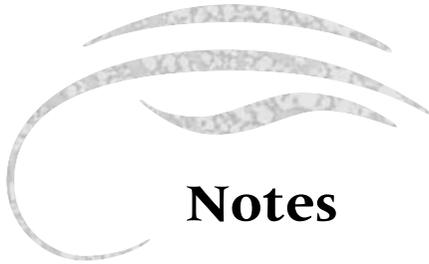
In the area of human development, a focus on quality will require additional resources, but more importantly, major improvements in service delivery. The agenda here is large, as reforms are primarily institutional in nature, and therefore require long-term, sustained efforts. For the medium term, progress in three areas will be particularly important: reforming the budget, strengthening public-private partnerships, and establishing better links between beneficiaries and service providers.

Reform of the budget should continue both to provide additional resources for human development and to improve the efficiency of public spending. Efforts to institute medium-term expenditure frameworks and effective monitoring and evaluation systems are useful initiatives that should be continued. Related improvements in financial management and procurement are essential to ensure that public spending is not being diverted into the wrong channels and is achieving the intended outcomes.

The example of human development progress in Bangladesh through public-private partnerships clearly indicates the potential for nurturing this institution, especially in a resource-constrained environment. The exact models of partnership will vary from country to country and will be guided by sociopolitical considerations, but the principles of what made this work in Bangladesh can be learned and adapted to specific country circumstances.

Better links between beneficiaries and service providers can be established in a variety of ways (World Bank 2003d). A decentralized approach to public service delivery with safeguard mechanisms to establish the accountability of the decentralized public entities is one potential route. One can draw on some positive examples of better service delivery from the experience of India's *panchayati raj* institutions. Other international experience, such as in countries of the Organisation for Economic Co-operation and Development, can also be relevant. What is clear is that continued reliance on the heavily centralized public institutions will not be helpful.

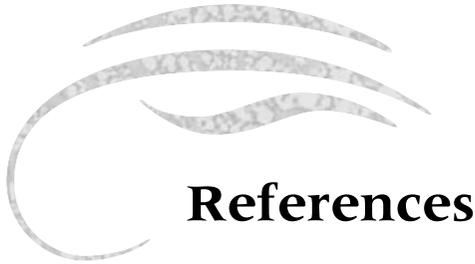
The observed increase in inequality and regional disparity in the South Asian countries is a source of serious concern that will need to be tackled. As noted earlier, inequality is not a necessary consequence of higher growth, but a reflection of inadequate public policy responses. A number of specific interventions could be helpful. First, policy reforms to reduce rent-seeking opportunities and improve access by the poor to finance and investment will be important. Second, institutional reforms related to a better investment climate and to human development will also help address the inequality problem. Third, budget spending to improve income-earning opportunities in lagging regions will also help. Fourth, improving the functioning of land markets to reduce transaction costs will be important as well. Finally, legal reforms that improve access by the poor to judicial support to speedily resolve disputes and protect them from exploitative behavior could be of assistance.



Notes

1. Papanek (1977) argues that accumulating assets in a balanced way is not necessary to achieve a high rate of growth as long as some assets are abundant. These abundant assets or factors could substitute for scarce assets or factors.
2. Devarajan (2005) makes similar points to those made in this section in explaining growth in the South Asian countries.
3. This work is pioneered by Chen and Ravallion (2000). The measure has been controversial and debate about its reliability at the country level has been extensive. The monograph will use this measure for regional comparison where the aggregation may be more robust and less controversial than the intercountry comparison. Poverty trends at the country level will rely on country estimates based on national sample surveys.
4. This is not to deny the role of inequality in influencing poverty outcomes, but appreciating and understanding the fundamental importance of growth in reducing poverty is important. Too often, the political debate tends to shift to a trade-off between growth, equality, and poverty, which can be quite misleading from a long-term perspective (see World Bank 2005a for an in-depth discussion of growth, equity, and poverty).

5. Weighted average rates.
6. In the case of India, size effects also need to be considered, but nevertheless, India's ratio is only 35 percent compared with a trade to GDP ratio of 60 percent for China.
7. Very recently, India has made good progress in improving port services.
8. The literature on this subject is vast. The Department for International Development (2004), Khan and Senhadji (2000), and Levine (1997) provide useful summaries of the literature and the underlying issues. Because financial sector mismanagement, including unduly rapid credit expansion, can also cause short-term disturbances that reduce growth, the literature now distinguishes between the short-term and long-term effects of financial intermediation (Loayza and Ranciere 2004).
9. Pakistan has progressed the most in reforming public banks through restructuring and privatization.
10. See Ahmed and Nath (2004) for a good example from BRAC's experience with the delivery of basic education.
11. The Gini coefficient based on the distribution of consumption may understate true income inequality in Pakistan, especially in rural areas, where land is extremely unevenly distributed (World Bank 2002a).



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“I read the [book] and found it excellent. It is really very good and very useful in terms of insight, data, comprehensiveness, and sound judgment.”

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“This is a very good and balanced account of South Asian economic development. Sadiq Ahmed argues persuasively that the main explanation for the region’s improved economic performance in the last 20 to 25 years is better economic policies. The breadth of the analysis is impressive, as is the author’s ability to distill the essence from complex, country-specific trajectories. It is a must-read for anyone interested in the destiny of South Asia’s 1.5 billion people.”

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“In recent times South Asia has emerged as one of the high-performing regions in the developing world. This book could not have come out at a more appropriate time as the development community seeks to understand the lessons of this experience.

Dr. Ahmed demonstrates in a short space, with a succinct and insightful analysis rich in relevant data and reflecting his long experience as a development practitioner, that appropriate policies—macro and sectoral—are the reasons for this achievement in both economic progress and human development in spite of weak but slowly improving governance. His conclusion that the acceleration of progress, as well as its sustainability, urgently require institutional reforms that are appropriately sequenced with additional policy reforms deserves a very wide recognition.”

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