WORKING PAPER NO.22

Economic Reforms, Growth, and Governance: The Political Economy Aspects of Bangladesh's Development Surprise

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

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Abstract

Bangladesh has in recent decades achieved reasonably rapid economic growth and significant progress in social development indicators despite many impediments: the desperate initial conditions after gaining independence, lack of resources, natural disasters, widespread corruption, and a record of systemic governance failure. By identifying the sources of growth stimulus and the drivers of social transformation, the paper addresses what it calls Bangladesh's development surprise. The policy-making process is analyzed as the outcome of incentives created by patronage politics as opposed to the compulsion for the government to play an effective developmental role. The paper examines the governance-growth nexus as affecting the pace and quality of growth and its inclusiveness. If the governance environment has been barely adequate to cope with an economy breaking out of stagnation and extreme poverty, it increasingly may prove a barrier to putting the economy firmly on a path of modernization and global integration. Bangladesh's experience also shows that it is possible to make rapid initial progress in many social development indicators by creating awareness through successful social mobilization campaigns and by reaping the gains from affordable low-cost solutions. Further progress, however, will require increased public social spending and improved quality of public service delivery.

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I. Introduction

Bangladesh emerged from its war of independence desperately poor, overpopulated, and reeling from overwhelming war damage to its institutional and physical capital. It was not until 1978/79 that per capita income had recovered to its pre-independence level. The economy was ravaged by acute food shortages and famines during the early years. According to some authors, Bangladesh was designated as a "test case" for development, and Henry Kissinger called it "an international basket case."[2]

More than 30 years later, doubts and doubters have been proven wrong. With sustained growth in food production and a good record of disaster management, famines have become a phenomenon of the past. Bangladesh's per capita GDP has more than doubled since 1975. Life expectancy has risen from 50 to 63 years; population growth rates of 3 percent a year have been halved, child mortality rates of 240 per 1,000 births have been cut by 70 percent, literacy has more than doubled, and the country has achieved gender parity in primary and secondary schools.

Most of these gains have taken place since the early 1990s, when the introduction of wide-ranging economic reforms coincided with transition to democracy. The growth of per capita GDP had been slow in the 1980s, at an annual average of 1.6 percent a year, but it accelerated to 3 percent in the 1990s, and to about 4 percent more recently (table 1). The acceleration resulted partly

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[2] See Faaland and Parkinson (1976).

from a slowdown in population growth but also from a sustained increase in GDP growth, which averaged 3.7 percent annually during the 1980s, 4.8 percent during the 1990s, and 5.7 percent since then.

Progress in the human development indicators was even more impressive. Bangladesh ranked among the top performing countries in the 1990s in the extent of improvement in the UNDP Human Development Index and it is among the few developing countries that are on target for achieving most of the Millennium Development Goals (World Bank 2003a, 2005).[3] As a result, Bangladesh is now clearly an overperformer in most social development indicators in relation to its per capita GDP, whereas two decades or so ago, it was in fact a laggard among countries with similar per capita income levels.[4]

Bangladesh's above achievements may appear as a "development surprise," given the country's desperate initial conditions and allegedly poor record in governance adversely affecting the investment climate and the quality of public service delivery (Ahluwalia and Mahmud 2004; Devarajan 2005; Mahmud 2008). Bangladesh is rated extremely poorly according to most global indicators of political and economic governance.[5] A number of questions have therefore been raised: How could the progress achieved thus far have been possible amid widespread governance failure and without concomitant institutional development? Is this progress sustainable and what are the risks and challenges ahead? How did the prevailing political economy environment shape the policy-making process, including the design and implementation of policies and their outcomes? This paper attempts to answer these questions.

II. Policy Shifts, Macroeconomic Trends, and Growth Performance

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

In the early years following the War of Liberation in 1971, economic management in Bangladesh was primarily aimed at reviving a war-ravaged economy in an overall framework of extensive state control and with an avowed ideology of socialism (Ahmed 2005; Mahmud 2008a). The state became the de facto owner of a large number of enterprises that had been abandoned by their

[3] The absolute increase in the value of the Human Development Index for Bangladesh between 1990 and 2001 is surpassed notably only by China among countries for which such estimates are available; UNDP (2003), pp. 241–44.

[4] Regressions with cross-country data show that the current values of most social development indicators for Bangladesh are distinctly superior to the predicted values at the given level of per capita income; see Government of Bangladesh (2005), Table 1, p. 9.

[5] See, for example, World Bank (2007), Volume II, Main Report, Chapter 7.

Pakistani owners. With the change of government and emergence of General Ziaur Rahman as the military ruler, following the assassination of Sheikh Mujib in 1975, there was a policy shift towards privatization and the promotion of the private sector.[6] The denationalization of the earlier abandoned enterprises continued at varying speed into the 1980s when a second wave of divestment was initiated under the military government of General Ershad.[7]

From the late 1970s to the beginning of the 1980s, there was a short-lived investment boom in both public and private sectors, with growth at nearly 15 percent annually in real terms (Mahmud 2001). This was made possible by relying on an increasing flow of foreign aid, adopting a privatization strategy based on lavish dispensation of cheap credit, and provision of other incentives such as highly protected markets for domestic industries. To a large extent, later problems regarding the so-called "sick" industries and the large-scale default of bank loans originated from this experiment with aid-dependent, state-sponsored private capitalism.[8] There was no mobilization of domestic savings, so that the investment boom ended abruptly when the external aid climate severely deteriorated in the early 1980s.

A major change of direction occurred in the early 1980s with the adoption of a market-oriented development strategy supported by a number of liberalizing policy reforms undertaken along the guidelines of the World Bank and the IMF and implemented under fairly rigid aid conditionality (Task Forces 1991). These reforms were initiated against the backdrop of serious macroeconomic imbalances, which had been caused in part by a decline in foreign aid and in part by a preceding episode of severe deterioration in the country's terms of trade. The policy reforms in the 1980s were mainly directed towards withdrawal of food and agricultural subsidies, privatization of state-owned enterprises, financial liberalization, and withdrawal of quantitative import restrictions. Nevertheless, many state controls remained along with heavy trade protection (Ahmed 2002).

The early 1990s saw the launching of a more comprehensive program of macroeconomic reforms, which coincided with a transition to parliamentary democracy from a semi-autocratic rule. These reforms particularly were aimed at moving towards an open economy and included such measures as making the currency convertible on the current account (leading to a floating exchange rate in 2003), reducing import duties generally to much lower levels, and removing virtually all controls on the movements of foreign private capital. There was also

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[6] General Ziaur Rahman later formed the Bangladesh Nationalist Party (BNP), which emerged as one of the two major political parties in Bangladesh, the other being Sheikh Mujib's Awami League.

[7] Like General Ziaur Rahman, General Ershad also later gave a civilian face to his regime by forming a political party, although his regime remained characterized by its autocratic style and lack of legitimacy.

[8] The subsequent decline of the development financing institutions (DFIs) was also closely linked to the shortcomings of that round of privatisation in Bangladesh (Mahmud 2001).

a tightening of fiscal and monetary discipline. The reforms also included further relaxation of restrictions on private investment, such as opening up telecommunications and power generation to private investment, financial liberalization with deregulation of interest rates, and fiscal reforms including the introduction of the value-added tax (Ahmed 2005; World Bank 2007).

Trends in Macroeconomic Indicators

The macroeconomic stabilization measures initiated in the 1980s were aimed at reducing the fiscal and external deficits to a sustainable level, partly in response to the reduced availability of aid. The trends in various macroeconomic indicators over the last two decades are shown in table 1. During the 1980s, although there was some success in reducing both the fiscal deficit and the external current account deficit, this was achieved at some cost. The macroeconomic balances were improved not so much by raising government revenue, domestic savings, or exports, but by squeezing public development spending, private investment, and imports (table 1). Thus, as in the case of most other early experiments in structural adjustment, the attempt to achieve macroeconomic stabilization in Bangladesh in the 1980s was made along the contractionary route.[9]

One reason why macroeconomic adjustment did not provide the required impetus to growth and resource mobilization was that the sectoral reforms needed to boost the supply response from the private sector were very limited. Numerous investment controls and trade protection prevented competition, and banking sector reforms did not happen.[10] Indeed, the lack of savings response and weak private investment may have been to a significant extent a reflection of the inefficient banking sector. Moreover, with deficits still deeply in the red and the inflation rate in double digits, the economy was not yet very stable.

[9] One redeeming feature of the macroeconomic developments in the 1980s as shown in table 1 is the increase in public investment. This increase, however, barely compensated for the decline in private investment, resulting in a slight decline in the overall investment rate. However, the actual investment scenario of the decade was probably much worse. The figures in table 1 are based on the revised national income series, which was initially estimated from 1990–91 onward, but was subsequently extended backward to cover the period of the 1980s. In spite of the improved estimation methodology used in the revised series, the investment estimates suffer from many weaknesses, which are likely to have been made worse through backward extrapolation. In fact, the old series show a substantial decline in the investment-GDP ratio during the 1980s, which is also borne out by a decline in the import of capital goods (see Task Forces, 1991). It is also highly improbable that public investment was increasing at a time when public development expenditure was being curtailed, although the two are not exactly the same.

[10] Banking reforms in Bangladesh started only after 2000. For a review of banking sector reforms and performance see Ahmed (2005).

Table 1. Macroeconomic Balances, 1980/81—2004/05; Five-Year Averages

	1980/81–1984/85	1985/86–1989/90	1990/91–1994/95	1995/96–1999/00	2000/01–2004/05
External sector					
Exports of goods and services	5.0	5.6	8.7	12.7	15.4
Imports of goods and services	14.4	12.8	14.0	18.6	21.0
Trade deficit	9.4	7.2	5.6	5.9	5.7
Workers' remittances[1]	2.7	2.9	2.9	3.6	5.8
Current accounts deficit[2]	6.7	4.7	2.1	1.9	1.5
Investment and savings					
Gross Investment	16.9	16.6	17.9	21.5	23.6
Public	4.8	6.1	6.7	6.8	6.4
Private	12.1	10.4	11.3	14.7	17.2
Gross domestic savings[3]	8.00	9.4	12.5	15.3	16.9
Gross national savings[4]	10.2	11.9	15.8	19.6	22.1
Government budget					
Total revenue	6.3	6.7	8.6	9.0	10.0
Tax revenue	5.2	5.4	6.9	7.2	8.4
Current expenditure	4.6	6.0	6.5	7.2	8.2
Development expenditure[5]	6.6	5.4	5.6	5.7	5.4
Total expenditure[6]	12.9	12.2	13.4	13.4	14.0
Budget deficit	6.6	5.6	4.8	4.4	4.0
Domestic borrowing[7]	1.0	0.5	0.8	1.9	2.2
Foreign financing[8]	5.6	5.0	4.0	2.5	1.8
Memorandum items					
Monetary policy					
Growth rate of real GDP (% p.a.)	3.7	3.7	4.4	5.2	5.4
Growth rate of population (% p.a.)	2.2	2.1	2.0	1.6	1.6
Inflation rate (CPI) (% p.a.)	13.0	8.0	5.6	5.6	4.3

Sources: Various publications of the Bangladesh Bureau of Statistics, Bangladesh Bank, IMF, and the World Bank.
Notes: Figures are in percentages of GDP at current market prices unless otherwise noted.
1. Remittances from Bangladeshi workers abroad.
2. Equals trade deficit minus net factor income from abroad; the latter includes private transfers (mainly remittances), interest payments on external public debt, and other investment incomes; differs from the official estimates because of not including official transfers (foreign aid as grants); a negative value implies surplus.
3. Equals gross investment minus trade deficit; also equals gross national savings minus net factor income from abroad.
4. Equals gross investment minus current account deficit.
5. Expenditure under Annual Development Plan (ADP).
6. Includes food account balance and certain capital expenditures and net lending not included in the development budget.
7. Includes net borrowing from the banking system and net sale proceeds of savings certificates.
8. Includes grants and concessional loans net of amortization.

The launching of wide-ranging policy reforms beginning in the 1990s was followed by some very positive developments in the economic performance. There was a marked improvement in the government's budgetary position, particularly in terms of increased revenue mobilization in the early 1990s (table 1). The growth of GDP has been accelerating in each successive period since the later half of the 1980s. While the net inflow of foreign capital has further declined to the current level of less than 2 percent of GDP, both investment and saving rates have steadily improved, thus paving the way for superior growth performance. Furthermore, the increase in the investment-to-GDP ratio has been almost entirely due to the dynamism in private investment, with the investment in the public sector remaining almost unchanged as a proportion of GDP. Meanwhile, due to robust and sustained growth in export earnings and the accompanying increase in imports, there has been a rapid increase in the trade openness of the economy (that is, the combined ratio of imports and exports to GDP).

All this was achieved along with remarkable success in keeping inflation under control. In the first half of the 1980s, the average annual rate of inflation as measured by the consumer price index was relatively high at 13 percent. It was only the contractionary effect of macroeconomic adjustment of that period that brought inflation down to around 8 percent in the second half of the decade. During the 1990s, there was further decline in the inflation rate, down to 5.6 percent in the 1990s and even lower since then, and this time the reduction in inflation was accompanied by the relative buoyancy of the economy compared to the preceding decade. The period since the early 1990s thus has seen positive developments on several fronts: transition to parliamentary democracy, strengthening of economic growth performance, and consolidation of economic stabilization in the face of declining foreign capital inflows. It appears that the combination of macroeconomic adjustment to stabilize the economy along with a range of structural reforms in trade, finance, and domestic deregulation spurred private investment and generated a strong supply response. This said, there were some periodic lapses in the macroeconomic discipline—particularly related to the timing of approaching national elections—thus producing the symptoms of the so-called "political business cycle."[11]

Sources of Growth Stimulus

All broad sectors of the economy—agriculture, industry, and services—contributed to the growth acceleration since the early 1990s. The average annual growth of agricultural GDP accelerated from 2.5 percent in the 1980s to 3.2 percent in the 1990s, industrial GDP from 5.8 to 7.0 percent, and the service

[11] In 1995–96 and 2000–01, both pre-election years, the government's domestic borrowing and the rate of credit expansion in the private sector were unusually high, while trade deficits increased substantially and foreign exchange reserves fell; see Mahmud (2004).

sector GDP from 3.7 to 4.5 percent.[12] In spite of some fluctuations in crop production, the volatility in long-term GDP growth in Bangladesh is found to be remarkably low among developing countries.[13]

Within manufacturing, the growth has come largely from the ready-made garment industry; during the 1990s, medium- and large-scale manufacturing as a whole grew at about 7 percent annually, but at only about 4 percent excluding the garment industry.[14] This implies that growth in the organized manufacturing sector has been mainly export-led. But it also means that the manufacturing and export base of the economy has become more concentrated rather than more diverse (table 2). The growth of export items lumped under "other exports" is an encouraging sign that continued improvement in export incentives might foster the needed export diversification. However, the values of these exports are still too low to allow a definite conclusion about whether diversification is already underway.

Bangladesh has achieved robust and sustained growth of export earnings, averaging about 15 percent a year in nominal U.S. dollar terms in the 1990s, and 11 percent since 2000 despite a 7.5 percent decline in 2001–02 because of a global recession—the first such decline since 1985–86. In fact, Bangladesh seems to have successfully withstood the initial impact of the competition in the global markets for garment export following expiration of the Multifibre Agreement (MFA) and the Agreement on Textiles and Clothing (ATC). Another positive factor has been continued growth of the inflow of migrant workers' remittances—from about 2.5 percent of GDP in the beginning of the 1990s to almost 8 percent in 2005–06, amounting to about US$4.8 billion annually.

Table 2: Bangladesh: Growth of Exports since 1990

Annual export earnings in US$ millions

Export item	1990/91	2004/05
Readymade garments and knitwear	890	6,418
Frozen foods (mainly frozen shrimp)	142	421
Raw jute and jute goods	395	404
Leather and leather goods	137	221
All other exports	154	1,190
Total exports	1,718	8,654
Of which, manufactured exports	1,411	8,006

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

[12] The estimates are derived from the official national income statistics. The industrial sector includes construction, mining, and utilities, besides manufacturing.

[13] World Bank (2003), pp. 7–8.

[14] These are estimated annual compound growth rates between the years 1991/92 and 1999/2000 and are based on the official national income statistics as reported in the annual *Statistical Yearbook of Bangladesh* of the Bangladesh Bureau of Statistics.

Exports are, however, only a part of the growth dynamics in Bangladesh. Though the structure of the economy is changing, the organized sectors of the economy still remain relatively small with no more than 12 percent of GDP currently originating from large- and medium-scale manufacturing. Agriculture still contributes about 20 percent of GDP, and a much larger share of GDP originates from the so-called informal sectors outside agriculture: small-scale processing and manufacturing and various informal services.[15] The growth rates of these informal activities accelerated in the 1990s, contributing substantially to the acceleration of overall GDP growth (Osmani et al. 2003). Many of these activities—being extremely labor-intensive and requiring very little capital investment—are largely demand-driven, responding to at least three major sources of increased income: crop production, readymade garment exports, and workers' remittances, in that order of importance.[16]

Though these informal activities have expanded largely as the result of demand linkages with the leading productive sectors of the economy, they have had their internal growth dynamics as well. There is evidence that their growth acceleration in the 1990s was accompanied by a tilt towards relatively scaled-up activities that use labor more productively and can cater to more income-elastic demand (Mahmud 2006). Import liberalization is likely to have played a role here by allowing better access to imported inputs and technology. For example, in the post-liberalization period, small-scale manufacturing activities (excluding handlooms and cottage industries) fared better than large-scale manufacturing, growing at an average rate of more than 9 percent annually in the 1990s.[17] Small industries seem to have benefited from the liberalization of imports of capital machinery and raw materials, whereas their products—being mostly remote substitutes for imported items—had an advantage over those of their large-scale counterparts, which faced stiffer competition from imports.[18]

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

It was out of pragmatism that the shift in policy away from socialism to private sector development was initiated within a few years after independence. The state policy of socialism, which was included in the declaration of independence, was hardly taken seriously and was formally deleted from the country's constitution during the Ershad regime. The operation of the nationalized

[15] According to the official 1999/00 Labor Force Survey, these informal activities employ about three-fourths of the country's nonagricultural labor force.

[16] For an estimation of the relative importance of these growth stimuli, see Osmani et al. (2003).

[17] Estimated annual compound growth rate between the years 1991/92 and 1999/2000.

[18] Small industries are likely to have grown also at the cost of cottage industries, whose value added grew at only 2.8 percent annually during the same period.

industries, previously abandoned by their Pakistani owners, was driven by the objective of enriching a few politically favored private individuals. But, as mentioned earlier, the initial process of private sector development as pursued during the regime of General Ziaur Rahman turned out to be an early version of what is now called "crony capitalism." The market-oriented liberalizing policy reforms were initiated around the mid-1980s with the support of the IMF and the World Bank, and have been followed through since then in various phases. Although aid conditionality did have an important leveraging role, the sequencing, design, and implementation of these reforms had much to do with the political incentives in relation to the economic rationale of such policies.

Reducing Agricultural and Food Subsidies

As part of the above reforms, the early emphasis on privatization of marketing of agricultural inputs and withdrawal of agricultural subsidies made sense on grounds of pragmatism. By the late 1970s, about one third of the entire development budget was being consumed by agricultural input subsidies. To promote modern rice technology, government policies had emphasized the public distribution of fertilizers and renting of publicly owned irrigation equipment at a heavy subsidy. These policies did have a major role in the initial adoption of the modern high-yielding variety (HYV) rice technology; but the budgetary costs became unsustainable. The rationale of providing input subsidies was also weakened once farmers became familiar with the use of modern inputs.

Debates on agricultural subsidies still reappear from time to time. The case for agricultural subsidies is made partly from a general populist stance, but partly also on grounds of helping poor farmers (who may lack access to credit to use inputs at optimal levels) and facilitating agricultural rehabilitation after natural disasters like floods. It is true that the withdrawal of high-input subsidies made rice production less profitable, since the subsidy withdrawal was not compensated by the avowed policy of supporting rice harvest prices through public procurement of rice—a policy that was hardly effective. Nevertheless, the promise of price support, along with the absence of strong agricultural lobbies, helped the implementation of the policy of subsidy withdrawal. According to the findings of "participatory" research conducted later to assess the impact of structural adjustment reforms, the farmers did not think the reintroduction of large subsidies on agricultural inputs to be a realistic proposition, but they did expect the government to have a role in supporting agricultural growth.[19] The same study also found that the farmers did not also expect their agricultural loans to be written off, although successive governments did include it in their

[19] This so-called Structural Adjustment Participatory Research (SAPRI) was sponsored by the World Bank in collaboration with a coalition of international NGOs and national governments; see Mahmud (2002a), Chap. 1.

election manifestoes. In this manner, electoral competition rather that genuine popular expectations seems to give rise to economic populism.[20]

Government control of tube-well irrigation was abolished through the sale of government-owned irrigation equipment and allowing free import of such equipment. The policy was criticized by some on the ground that it favored the big farmers who emerged as the major suppliers of water to smaller farmers at a high price, particularly since such irrigation is like a natural monopoly in the so-called "command area" of a tube-well.[21] This argument, however, did not gain much ground as subsequent evidence showed that the policy led to a spurt in private investment in tube-well irrigation contributing to growth in food grain production.[22]

At about the same time as agricultural subsidies were being reduced, public food distribution in the form of food rations in urban and rural areas was also gradually phased out. The budgetary burden was again a consideration, but there was also a widely held view, supported by study findings, that the poorest families did not have access to the food rations. Even then, the abolition of the food rationing system was not an easy decision, given that the politically vocal urban middle class was its main beneficiary. In many other countries, attempts to abolish such food rations met with violent political protests. The success of the reform program regarding the public food distribution system in Bangladesh is partly explained by its gradualism and its clever design. In the years of high food grain prices, the ration prices were raised without creating much resentment (because of still higher market prices), but the ration prices were not reduced in years of low market prices (which again was acceptable, since only an increase in ration prices was a sensitive issue). The gap between the market and ration prices was thus gradually reduced, so that ultimately there was little incentive for the beneficiaries to access such rations (Rahman and Mahmud 1988). On the other hand, there was a strong case on equity grounds in support of the policy to continue, and even strengthen, the food distribution programs targeted to the poor, such as those relating to food-for-work and feeding vulnerable women and children.

External Sector Reforms

The reforms towards trade liberalization in Bangladesh followed a logical sequence: the relaxation and withdrawal of import quota restrictions along with the unification of the exchange rate and devaluation of the domestic currency during the late 1980s, followed by large reductions in import tariffs in the first half of the 1990s. But since then further import liberalization has been rather

[20] Populist policies should be, however, distinguished from the genuine need to incorporate the "voice" and participation of the people in economic decision-making process; see Mahmud (2002a), Chapter 1.

[21] Khan and Hossain (1989), p. 164.

[22] Ahmed (2001), Chap. 5.

slow. Taking into account all import duties having a protective effect, the unweighted average import duty rate declined from 74 percent in 1991-92 to 32 percent in 1996-97 and 24.3 percent in 2006-07 (table 3). The slower decline since the mid-1990s is partly because cuts in customs duties were offset by other protective duties and para-tariffs (World Bank 2005a; Mahmud 2004). As a result of these reforms, Bangladesh still has a relatively closed economy.

The devaluations of the exchange rate of the taka—both in nominal and real terms—during the late 1980s, along with relatively sluggish growth in import demand of that time, resulted in a gradual erosion of the premium on import licenses. There were thus no strong lobbies of import-license holders opposing the reforms. The removal of import restrictions and a flexible management of the exchange rate eventually led to making the taka convertible on the current account and, more recently, in a system of managed free float. This helped to provide incentives for export as well as for attracting migrant workers' remittances from abroad.

An important concern regarding trade liberalization is the possible adverse effect of tariff reductions on government revenue. Thus far, the revenue effects of reductions in the rates of customs duties have been more than offset by the growth of imports (Mahmud 2004). More than half of total tax revenue still comes from import duties, even though the introduction of the value-added tax has reduced the dependence on such duties. In fact, revenue concerns rather than protectionist appeals seem to have a stronger deterrent to faster import liberalization. This is evident from the pattern of reductions in import duties: the government sought to protect revenue by reducing tariff on minor items rather than those with a large recorded import value.[23]

Table 3. Average Rates of Customs Duties and All Protective Import Duties[1]

	1991/92	1995/96	2003/04	2006/07[2]
Average customs duty, unweighted (%)	70.6	28.7	18.8	14.9
Total protection rate, unweighted (%)[3]	73.6	32.0	29.1	24.3
Average collection rate (%)[4]	28.7 (37.4)	23.7 (31.8)	18.0 (25.5)	n.a.

Source: Estimated from World Bank (2005a), Table 3.1, p. 16.

Notes:

1. The average rates reported here are based on 8-digit 6877 tariff lines; they do not include tariff exemptions or concessions, nor do they reflect "preferential" tariffs.
2. According to the budget for the financial year 2004/05.
3. "Total protection" incorporates, in addition to customs duty, protection provided by the Infrastructure Development Surcharge, License Fee (LF), Regulatory Duty (RD), as well as protection resulting from asymmetric implementation of the Supplementary Duty and VAT. Asymmetric implementation results when the so-called protection-neutral taxes are levied on only imports but not on domestic production and/or when higher rates are applied on imports than on domestically produced substitutes.
4. The collection rate reflects tax exemptions as well as tax evasion, and includes duties on all lines of import items, but not the advance income tax on imports. Figures within brackets relate to imports, excluding duty-free export-related ones.

[23] As a result, for the period of rapid tariff reductions in the early 1990s, the import-weighted estimates of average import duty rates (both in respect of total import duties and protective duties) showed a much smaller decline than the unweighted estimates; see Mahmud (2001), p. 55.

One reason why tariff reforms have not been strongly resisted by domestic industrial lobbies is the end-use-based discrimination in protective duty rates. Capital goods and primary commodities are subject to much lower rates of tariffs compared to intermediate goods, while the highest rates apply to finished consumer goods. This has helped to retain relatively high rates of protection for the later goods even within the much lower average import tariffs; at the same time, the anti-export bias of the tax system has been reduced to some extent because of lower taxes on imported inputs. Such a system of tariff escalation has suited the interest of the protectionist lobbies, since the domestic import-substituting industries mainly produce finished consumer goods.[24] But even within such a policy of tariff escalation, revenue concerns dominated over protectionist ones, so that duties on major imported intermediate goods remained higher than those on relatively minor ones (as reflected in the higher estimated import-value-weighted average duty rate compared to the unweighted rate in respect of this category of imports).

The prospect for export growth and diversification may provide further leverage for import liberalization. Most industrialists in Bangladesh now have a stake in the export-oriented garment industry. The other fast-growing industries like pharmaceuticals and ceramics have gone into the export market after graduating from being entirely import-substituting industries. This may weaken the resistance to further reducing the anti-export bias in the duty structure that now exists.

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

[24] The system of incentives thus created has worked against a "deepening" of the domestic manufacturing structure, making it even more import dependent In particular, there is evidence that the reforms of the duty structure have thwarted the growth of a nascent domestic engineering and capital goods industry; Mahmud (2004).

Fiscal Policy and Public Expenditure

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

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

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

Table 4. Government Expenditure on Health and Education
(as shares of the budget and as percent of GDP)

	1980/81–1984/85	1985/86–1989/90	1990/91–1994/95	1995/96–1999/00
Percent of total budget expenditure				
Education	8.16	11.24	13.62	15.51
Health & population planning	5.40	5.88	6.77	7.13
Percent of GDP at market prices				
Education	1.00	1.33	1.81	2.11
Health & population planning	0.66	0.70	0.90	0.97

Source: Based on the official "revised budget" figures as reported in *Bangladesh Economic Survey*, Ministry of Finance, various issues.

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

Governance, Political Incentives, and Policy Making

It is generally agreed that economic reforms in Bangladesh have not been matched by progress in building the institutions of political and economic governance (Mahmud 2001; Ahmed 2005). The degree of resistance to reforms of different kinds depends on the nature of prevailing political cultures. Bangladesh has successfully implemented many reforms that are usually considered unpopular and vote-losing, such as the withdrawal of agricultural and food subsidies affecting large sections of the population. Considerable progress has also been made in implementing reforms that are liable to antagonize organized militant groups who can create short-term disruption through agitation, such as the trade unions resisting the privatization of state-owned enterprises. In some areas of reforms, however, the government did hesitate in taking tough actions because of the fear of a backlash from the voters or organized labor (for example, adjustment of energy prices, or privatization of ports and public utilities).

By and large, Bangladesh did not see any significant reversal of reforms, even as governments changed, because both the large parties—the Awami League and the Bangladesh Nationalist Party (BNP)—were broadly committed to carrying out the same economic reform agenda. However, the relative emphasis on specific policies and interventions did differ significantly. Thus, the Awami League, whose vote bank tends to be more populated by rural residents and low-income groups, maintains a more populist and left-wing stance in its policy interventions reflected in greater support for rural spending and agricultural subsidies and less enthusiasm about privatization and trade liberalization. The BNP on the other hand is relatively more dominated by urban and business

interests and therefore has been generally more enthusiastic about pro-market reforms.

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

The above structure of governance provides an ideal breeding ground for corruption through the exercise of large discretionary powers with little accountability. Spoils and privileges are parceled out to different clientele groups as an essential tool of political management. On top of this, a large part of the bureaucracy is seen to be corrupt and incompetent, which further feeds this vicious cycle of poor governance. Economic liberalization has no doubt contributed to reducing the scope of rent-seeking, such as from the import licensing system, but this has been increasingly replaced by other means of patronage politics.[25] The overall evidence suggests that if there is a demand in the political system for illegal incomes and rent-seeking, economic reforms alone will not be the remedy (Mahmud 2001).

In spite of the adverse governance environment, there is ample evidence that the government has been committed to playing a major developmental role. This is reflected, for example, in the government's budgetary allocations that have been broadly in concordance with its development goals. The compulsions of meeting public expectations and gaining political legitimacy in an environment of widespread political awareness of the people seem to have played a role.[26] In fact, certain yardsticks for judging the merits of the budget proposals are now generally accepted in Bangladesh. One such yardstick, for example, is whether there is enough fiscal prudence to contain inflation and ensure economic stabilization. Raising higher revenue and containing the growth of

[25] For example, while new laws have been introduced to make the public procurement system more transparent and accountable, the system has hardly worked. Moreover, financial extortion (including illegal collections of tolls and protection money) under political patronage has been an increasing phenomenon contributing to the cost of doing business.

[26] Thus, any deviant political motives have to remain as a hidden agenda, only to be pursued at the time of implementation of the budget; see Mahmud (2002).

administrative expenditures, so as to generate more domestic resources for development spending, are regarded as a broad goal of budgetary measures. Within development spending, the higher is the benefit seen to be going to the poor, the better. And there seems to be a compulsion for the Finance Minister to show (even with some jugglery of data, if needed) that the allocations to education are larger than the defense budget.

Even if the delivery of public services suffers from a serious governance problem, the government has shown genuine commitments to improve social development indicators, such as child mortality, primary school enrollment, and the adoption of modern birth control. Support from external donors has definitely helped to achieve these goals, but it cannot be said that the increased budgetary allocations and other public measures for achieving these goals have been dictated largely by aid conditionality.[27] The government also appears to have been genuinely committed to poverty reduction as indicated by increased spending and expansion of various schemes to achieve this goal. The government has not only had a record of good disaster management at times of, say, severe floods, but it has also shown sensitivity to reported incidences of seasonal poverty in certain poverty pockets.[28]

There may be other explanations as to why some reforms were possible and others not. Broadly speaking, in selecting reforms successive governments have pursued the path of least confrontation and adopted reforms that were more in the nature of easy wins accomplished by "a stroke of the pen.". Thus, many of the reforms in the area of macroeconomic management could be implemented without much political resistance. For example, the country's bad experience with runaway inflation during 1972–75 created the political support for tightening macroeconomic management. Similarly, the disastrous experience with nationalization and controls in this period was easy to dismantle because most people (except possibly trade unions) saw the merits of doing away with a controlled economy and move towards a private sector–led development strategy. Also, the support for social spending was seen as a political win-win since the members of parliament could take credit for the expansion of health and education programs in their constituencies. This was good for their vote banks, and such spending also provided business opportunities for their clients.

The parliamentarians' political agenda of the creation of vote banks through control over the delivery of public services has obvious downsides. Members of

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

[28] This is evident from the recent initiatives taken by the government to mitigate seasonal poverty, locally called *monga*, in some vulnerable areas in the north-western part of the country.

parliament, instead of being concerned with lawmaking and national policies, become lobbyists for procuring projects for their respective constituencies—by no means a healthy process of selection of development projects. Much of the wastage in public resource management at the local level, such as the alleged leakage of resources in the rural works program, is the result of the above system. It also partly explains many weaknesses in the implementation of local development projects, which nonetheless have benefited the local communities.[29] The confluence of public good and political incentives is thus at best partial.

The policy reforms in the banking sector provide an example of how the opposing compulsions of patronage politics and sound economic order have shaped the evolution of such reforms. The banking sector has long been suffering from the widespread culture of willful default in loan repayment. The reasons for loan default on such a large scale have been many, such as politically influenced loans given by state-owned banks, "insider" loans given by private banks to their sponsor-directors, and the weakness of legal provisions for loan recovery. The adverse economic effects of such fiduciary indiscipline gradually took unsustainable proportions and created widespread public resentment. Public opinion against loan defaulters was reflected in the introduction of a law in 1996 debarring such defaulters from participating in national elections. Bold banking reforms were subsequently adopted to prevent banks from giving more loans to defaulters, to remove unscrupulous sponsor-directors from the boards of the private banks, and to make the state-owned banks more disciplined and autonomous for their eventual privatization.[30]

One important development in Bangladeshi politics is that business interests have gradually gained influence over politics. The country's first parliament had few members whose principal occupation was business (politicians traditionally coming from the profession of law); the latest parliament was, however, dominated by businessmen. This transformation in politics has had an important impact on the policy-making process. A parliament dominated by businessmen would try to enact or prevent laws in order to protect their sources of income, legal or illegal. It was only because of the pressure of public opinion that the legislature had to ultimately pass laws against the defaulters of bank loans. There are also many examples of how businessman-turned-politicians exercised political influence to earn illegal incomes, but later moved into legitimate businesses. One potential advantage of the rise of this new breed of lawmakers is the effective pressure they can create for promoting their legitimate interests, such as provision of better infrastructure, including power supply and port facilities. But this advantage will materialize only if the conflict of interest

[29] For example, as noted earlier, disproportionately more funds are allocated for constructing new local roads rather than for the maintenance of the existing ones; the former is perceived as public service rendered by the local member of parliament, the latter as only the routine work of the concerned government agencies.

[30] For a detailed account of these reforms, see Mahmud (2005).

between law making and pursuit of personal business can be managed through appropriate legal safeguards.

It would appear that public economic functions are influenced by both adverse and beneficial political incentives. Given the weaknesses of the democratic institutions, there is hardly any effective oversight mechanism to ensure the accountability of the government's fiscal operations and other economic functions. However, the national elections since 1991, held under a unique system of a nonparty caretaker government, have been seen as fair and credible. People seemed to have demonstrated a willingness to move against regimes once they crossed some vaguely defined threshold with respect to poor governance and corruption, as evidenced by the fall of the successive governments led by the Awami League and the BNP. This has created an incentive structure in which public representatives try to respond to the genuine popular sentiments in order to win reelection while still engaging in rent-seeking activities. There also seem to be at work some noninstitutional mechanisms for ensuring public accountability, such as through civic activism, a lively media, and widespread political awareness among the people at large. This probably explains why, in spite of many perverse political incentives embedded in the system, governments have played overall an effective developmental role.

IV. Explaining the "Development Surprise"

Bangladesh's impressive record of economic growth and social development has been achieved despite apparently poor governance. Bangladesh is thus an outlier in cross-country comparisons relating governance to economic growth.[31] Recent studies show increasingly compelling evidence that good governance matters to growth, although there are many controversies surrounding these studies regarding the definition of "good governance," the biases in perception of governance, the direction of causality, and the problem of isolating the effects of country-specific institutional and other factors in explaining cross-national variations. Although it is quite evident that Bangladesh's economic performance has been negatively affected by some of the adverse governance factors, the more interesting question relates to why the country's economy has performed in the way it has despite wide-ranging governance failures.

Deconstructing Growth

To understand Bangladesh's development conundrum, one needs to deconstruct the economic growth process and focus on the main drivers behind accelerated growth. As discussed earlier in this paper, the acceleration of growth of the Bangladesh's economy since the early 1990s has been underpinned by strong export growth, led almost entirely by the growth in readymade garment export.

[31] World Bank (2007), Volume II: Main Report, Chapter 7 and Figure 7.

The garment industry has flourished in Bangladesh because of the confluence of a number of favorable factors: the early relocation of garment producers and marketing intermediaries from East Asian countries (especially the Republic of Korea) to Bangladesh to evade import quotas in the U.S. and European markets; easy transfer and spread of garment-industry-specific managerial and production skills; preferential access of Bangladesh's garment exports in the major markets of the West; a flexible exchange rate policy and other policies adopted by the government in supporting the industry, specially by creating a set of enclave-type arrangements (for example, bonded warehouses and back-to-back letters of credit to facilitate duty-free import of fabrics); and the abundance of low-cost female labor.[32] Once the growth of the industry gathered momentum and became the main exchange earner, it gained in efficiency and could exercise more clout in shaping government policies in its favor.

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

Strong export growth has contributed to GDP growth both directly and indirectly by providing growth stimulus to other parts of the economy. There is also an indirect route through which export growth, coupled with import liberalization, has helped the growth in small-scale and informal sector activities. These later activities produce mostly nontradables or poor substitutes for imports. A real devaluation of the taka can hurt these activities by increasing the prices of imported inputs and by turning the domestic terms of trade against their products compared to tradable products. But thanks to rapid growth of export and remittances, the real exchange rate of the taka remained more or less stable at a time when there was substantial import liberalization and a marked decline in external deficits.[33]

Besides garment export, growth impulses have come from workers' remittances and from growth in agriculture and in small-scale industries and services, mostly belonging to the informal sector. The government has pursued

[32] Easterly (2002, Chapter 8) elaborately describes how, by some historical accident, the Korean firm, Daewoo, and an influential Bangladeshi bureaucrat-turned-industrialist, Noorul Quader, got together to start the process of transfer of knowledge and skills for setting up an export-oriented garment industry.

[33] During the same period, the currencies of many developing countries, including India and Pakistan, underwent massive real devaluation; see Mahmud (2004, 2007).

policies since the early 1980s to encourage manpower export and attract remittances by negotiating with host countries, offering favorable exchange rates for workers' remittances during the previous exchange control regime, and facilitating remittances through banking channels by various means. Growth in agriculture has been helped by market-oriented reforms in agricultural input markets as mentioned earlier. Moreover, because both agriculture and informal sector activities mostly remain outside the purview of the government's regulatory functions, these are likely to be less adversely affected by poor governance compared to the activities in the modern organized sectors of the economy.[34]

The growth of the urban centers, foremost among them Dhaka, has greatly contributed to economic growth by creating the complementarities that accompany urban growth. Dhaka, with 12 million inhabitants, has seen an eight-fold increase in its population since 1970 and is reckoned to be among the two fastest-growing megacities in the world.[35] Not least because of the rapid growth of the export-oriented garment industry and the flow of remittances and the related housing construction boom, urbanization has been accompanied by job creation strong enough to accommodate over 10 million new entrants to the workforce between 1996 and 2003.[36] Study findings show that rural-to-urban migration, instead of being mainly driven by the so-called "push" factors, has been generally a means of upward economic mobility for the migrants (Khundker et al. 1994). Nevertheless, the problem of poor governance manifests here in the form of unplanned urbanization creating huge problems for the future.

In the rural areas, the nonfarm sector has become more diversified, productive, and dynamic, especially with the growth of the rural towns. The clusters of habitation around these rural towns have helped to promote those nonfarm activities that can cater to urban-like and income-elastic consumer demand; and these are the kinds of activities that are found to have shown more dynamism within the rural nonfarm sector in terms of improved technology and higher labor productivity (Mahmud 2006). Very rapid expansion of microcredit since the early 1990s is also likely to have played an important part in this process.

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[34] There is, however, evidence that with a deterioration of law and order, small-scale and informal sector activities can be more vulnerable to illegal extortion and toll collection than larger-scale enterprise in terms of the proportionate increase in the cost of doing business; see Mahmud (2006), p. 42.

[35] Lagos in Nigeria is the other.

[36] World Bank (2007), Volume II: Main Report, Chapter 5. See also Acharya (2006) who explains the contrasts between Dhaka's commercial and construction boom and the lack of it in Kolkata and Mumbai.

Growth Inclusiveness and Poverty Reduction

With the acceleration in the growth of per capita income, Bangladesh has made considerable progress in poverty reduction. During the 1990s, the national incidence of poverty declined from nearly 60 percent to about 50 percent; and a much more rapid reduction in poverty seems to have taken place in the following five-year period with the national poverty rate reduced to about 40 percent.[37]

More progress against poverty would have been made in the 1990s had income distribution not worsened in both rural and urban areas. In the recent periods, growth acceleration in many developing countries, including in South Asia, has been accompanied by increased income inequality (Devarajan and Nabi 2006; Mahmud and Chowdhury 2008). The growth-inequality links in the case of Bangladesh seems to be, however, of a different nature. The pattern of growth in Bangladesh would appear to be fairly pro-poor—with the main stimulus to economic growth coming from labor-intensive garment exports, micro- and small-scale enterprises in manufacturing and services, and remittances from migrant workers. All these sectors typically provide scope for upward economic mobility for the poor. Even then, inequality tended to increase because the more dynamic parts of the economy happened to be the ones with relatively unequal income—such as the urban/organized sector compared to the rural/informal sector or the dynamic part of the rural nonfarm sector compared to agriculture—and also because growth, though employment intensive, was not strong enough to pull wages in the vast agricultural and informal intensive markets.[38]

However, the estimates for the most recent period from 2000 to 2005 suggest that the process of increasing income inequality has slowed down or even reversed. As a result, the impact of income growth on poverty reduction has been much more pronounced during this period than in the 1990s (table 5). Real wages in agriculture and construction—the sectors dominated by informal intensive markets—have shown strong upward trends since the late 1990s, after having been stagnant for a long time.[39] It would thus appear that Bangladesh is perhaps past the turning point of the "Kuznets curve" in the income-inequality link.[40]

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[37] The official poverty estimates are made with reference to an "upper" and a "lower" poverty line. The national poverty incidence, according to the lower poverty line is estimated to have declined from 43 percent in 1991/92 to 34 percent in 2000 and 26 percent in 2005.

[38] See Osmani et al. (2003); Mahmud (2006).

[39] World Bank (2007), Volume II: Main Report, Figure 3.7, p. 43.

[40] Although the general validity of the Kuznets process has not been borne out by recent cross-country experience (see, for example, Anand and Kanbur 1993), this does not imply that it cannot be valid for specific country situations.

Table 5. Trends in Poverty and Income Distribution in Rural and Urban Areas, 1991/92 to 2005

Year	Percent of population under poverty line			Gini coefficient of consumption expenditure		Urban-rural ratio of per capita expenditure
	Rural	Urban	National	Rural	Urban	
1991/92	61.2	44.9	58.8	0.24	0.31	1.65
2000	53.0	36.6	49.8	0.27	0.37	1.87
2005	44.5	28.8	40.6	0.28	0.35	1.67

Source: Reports of the various rounds of the *Household Expenditure Survey* published by the Bangladesh Bureau of Statistics (2003, 2006).
Notes: The poverty estimates are those of the Bangladesh Bureau of Statistics relating to the "upper poverty line" and derived from a cost-of-basic-needs methodology. The Gini coefficients are estimated by adjusting per capita income for spatial price variations; but urban-rural ratios relate to nominal per capita consumption expenditure.

Recent analyses of poverty dynamics in Bangladesh suggest that, compared to many other developing countries, upward economic mobility in Bangladesh is less constrained by class, ethnicity, or other socioeconomic barriers. Access to markets with extensive rural transport networks, increasing participation of women in work outside home, and a very rapid spread of microcredit have all contributed towards expanding the economic opportunities for the poor. Thus, everyone, even the poorest, see a chance of escaping poverty.[41] Such inclusiveness may contribute to social cohesion and it also raises awareness about economic opportunities, which may explain why even poor families are increasingly sending their children to school. But it may also raise people's expectations and lower their tolerance for governance failure.

Social Development: The Most Striking Development Surprise

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

How could these achievements be made in spite of still widespread poverty, relatively low though increasing public social spending, and the poor governance of service delivery systems in Bangladesh? The improvements in the human development indicators reflect a process of social transformation that is of a much broader scale and dates back to earlier decades (Mahmud 2008). Much of this progress has resulted from adoption of low-cost solutions like the use of

[41] This is not to underestimate the problem of persistent or chronic poverty in Bangladesh. For empirical evidence, based on longitudinal studies, about the economic mobility of the poor, see Sen (2003) and Rahman and Hossain (1995), Chapter 7.

oral rehydration saline (ORS) for diarrhea treatment, leading to a decrease in child mortality. More progress has come from increased awareness created by effective social mobilization campaigns such as for child immunization or contraceptives or female child enrollment. The scaling up of programs through the spread of new ideas is helped in Bangladesh by a strong presence of nongovernmental organizations (NGOs) and also by the density of settlements and their lack of remoteness.[42] Public support in the form of many innovative interventions also helped.

Thus far, Bangladesh has not followed the typical pathways to human development, such as the income-growth-mediated path of Korea or the public-spending-driven path of Sri Lanka.[43] This is evidenced by the fact that, while Bangladesh compares favorably with some of the socially progressive states of India, it lags far behind those states both in per capita income and per capita public social spending in absolute terms (Mahmud 2008). But this also implies that further progress will require following either or both of the above pathways, as the gains from low-cost easy solutions are reaped and the amount of public spending, quality of services, and synergies with income-poverty all become important. Nevertheless, Bangladesh's experience shows that it is possible to make rapid initial progress in social development by creating public awareness and using low-cost affordable solutions, and also that social attitudes and behavioral norms can change over a much shorter period than usually assumed in the literature of institutional economics (see, for example, North 1997).

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

Indicators		1990	2002–04
Gross primary enrollment rate (%)	Bangladesh	80	109
	South Asia	*95*	*103*
Ratio of girls to boys in primary and secondary education (%)	Bangladesh	77	107
	South Asia	*71*	*89*
Under-5 mortality rate (per 1,000 live births)	Bangladesh	144	69
	South Asia	*130*	*86*
Population with access to improved sanitation (%)	Bangladesh	23	48
	South Asia	*20*	*37*

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

[42] It is noteworthy that, according to the World Bank's *World Development Indicators 2005*, the percentage of children with diarrhea who were treated with oral saline was estimated at 61 percent in Bangladesh compared to 27 percent in India.

[43] Sen, for example, distinguishes between 'income-mediated' and 'support-led' human development; see Sen (1999), Chapter 2.

Unbundling Governance

The governance-growth nexus needs to be understood in the individual country contexts, in which institutions, historical and cultural settings, and the stage of development will matter. Most international comparisons show relatively poor perceptions of governance in Bangladesh. For example, in the most recent governance data set released by the World Bank Institute for 2005, Bangladesh's ranking among 210 countries varies from bottom seventh to thirty-second percentile in the six indicators: 6.6 for political stability, 14.9 for regulatory quality, 19.8 for rule of law, 7.9 for control of corruption, 21.1 for government effectiveness, and 31.4 for voice and accountability. Bangladesh's position is significantly worse than its South Asian neighbors in most indicators; only in respect of voice and accountability it is ahead of Nepal and Pakistan. The information from the surveys on Investment Climate and Doing Business carried out by the World Bank Group is also not encouraging for Bangladesh in most respects.[44] Even more discouraging is Bangladesh's very poor ranking in the economic competitiveness index prepared by the World Economic Forum.[45]

In some respects of governance, however, Bangladesh does well. For example, Bangladesh ranks among the top 50 percent of the countries in terms of the ease of doing business according to the World Bank's Doing Business survey of 2006. It actually ranks above many developing countries in terms of investor protection.[46] The perception indices may also neglect many ground-level realities. Although Bangladesh scores very poorly in terms of enforcements of contracts, casual observation suggests that local business people do not regard it as any great hindrance in an environment where such enforcement can be biased to favor them and where informal methods based on business mores and customs and reputation play an important role. The corporate tax regime is relatively liberal in Bangladesh and profits are fairly high in formal sector enterprises.[47]

As discussed earlier, Bangladesh has in fact enjoyed governance successes in some key areas. The state has created space for the emergence of a vibrant domestic private sector. It has done this by various policy reforms aimed at maintaining macroeconomic stability, keeping fiscal deficits low so as not to crowd out bank lending to the private sector, providing access to imported inputs through import liberalization, increasing competition by reducing entry barriers, and improving the central bank's oversight functions in respect of commercial banking. The successive democratically elected governments have been able to make fairly prudent public expenditure choices. The disaster

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[44] World Bank (2007), Volume II: Main Report, Chapter 7.

[45] Bangladesh ranks 98th out of 102 countries in business competitiveness according to the World Economic Forum's Global Competitiveness Index.

[46] In terms of investor protection index, Bangladesh scores 6.7 compared to the OECD average of 6.0 and the South Asian average of 5.0.

[47] The World Bank's Doing Business survey does not take account of business profitability.

management capacity of the government has also improved significantly over the years. The state has created space and forged partnerships with NGOs and the private sector to help deliver social services. And there has also been a certain degree of continuity in policy in spite of changes in government. Overall, the state has played a significant developmental role.

V. Concluding Remarks: Future Challenges

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

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

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

Strong export growth is key to achieving any impressive growth performance of the Bangladesh economy. Bangladesh has made the transition from being primarily a jute-exporting country to a garment-exporting one. The transition has been dictated by the country's resource endowment, characterized by extreme land scarcity and a very high population density, which makes economic growth dependent on the export of labor-intensive manufactures. It is not, however, easy for a least-developed country like Bangladesh to specialize in manufactured exports. Having low wage costs can hardly compensate for its relative disadvantage in marketing skills and infrastructure (including transport, ports, product standards, and certification facilities). Thus, Bangladesh's export base remains low as the impressive success in garment export has yet to be replicated in other industries. Indeed, Bangladesh's experience with the garment industry has demonstrated the limitation of relying on enclave-type arrangements to facilitate export growth in a specific activity, while postponing institutional reforms for improving the investment climate generally.[48]

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

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

Without some political incentives, attempts at institutional reforms are unlikely to have much success. As mentioned earlier, the reforms in the banking sector could make progress in spite of strong vested interests because the government has realized the key importance of such reforms in maintaining a sound economic order. In some other key sectors, however, such incentives have

[48] On these issues, see Mahmud (2007).

not worked. In power generation, potential private investors have been put off by the interference of vested interests in the tendering and negotiation process. The result is an acute power shortage that has not only proved to be a brake on economic growth but also a source of great embarrassment for the erstwhile BNP government. Successive governments have also neglected to improve the management of the Chittagong port, which suffers from the corruption in the customs procedures, deficient logistical capacity, and the interference of highly politicized labor unions. As a result, the only major seaport of the country ranks among the world's least efficient container ports.

Bangladesh's economic growth prospects will ultimately depend on the viability of its core systems of political governance. Will political governance improve through increased civic activism and a lower tolerance shown by the public for weak governance? Or will the internal dynamics of the system lead to a "path-dependent" institutional deterioration as postulated by Douglass North?[49] Bangladesh's recent political developments show both these tendencies. On the one hand, there is no evidence of as much elite capture of the system as one would expect from the country's image of being one of the most corrupt and ill-governed countries. On the other hand, patronage politics and a winner-take-all system as exists in Bangladesh seems to have resulted in more and more rent-seeking as an essential means of political management, thus raising the stakes in winning elections and rendering the system increasingly unsustainable. The shape of Bangladesh's political and economic future will largely depend on which of these opposing forces will prevail.[50]

[49] See, for example, North (1997).

[50] After three reasonably fair elections since 1991, the elections scheduled for late 2006 had to be postponed under the threat of extreme political unrest. This has prolonged the tenure of the present non-party caretaker government and has broadened its mandate beyond holding the elections. The popular expectations are that this government will bring about the necessary institutional changes to put the governance framework on a proper footing again.

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