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THE MACROECONOMICS OF POVERTY REDUCTION: THE CASE STUDY OF BANGLADESH

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ACRONYMS AND ABBREVIATIONS

ADB	Annual Development Plan
ATC	Agreement on Textiles and Clothing
BBS	Bangladesh Bureau of Statistics
BIDS	Bangladesh Institute for Development Studies
CBN	Cost of Basic Needs
CHT	Chittagong Hill Tracts
ESP	Essential Service Package
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment
FFE	Food For Education
FGT	Foster Gree Thorbeck
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GOs	Government Organisation
GOB	Government of Bangladesh
GSP	Generalised System of Preferences
HES	Household Expenditure Survey
HIES	Household Income and Expenditure Survey
LDCs	Least Developing Countries
LFS	Labour Force Survey
MFI	Micro Finance Institution
MFN	Multi Fibre Agreement
NCBs	Nationalised Commercial Banks
PCBs	Private Commercial Banks
REER	Real Effective Exchange Rate
PKSF	Palli Karma Sahayak Foundation
RMG	Ready Made Garments
RNF	Rural Non Farm
ROA	Return on Asset
SOEs	State Owned Enterprises
STW	Shallow Tube Well
VAT	Value-Added Tax
VSS	Voluntary Separation Scheme
WTO	World Trade Organisation
WB	World Bank

EXECUTIVE SUMMARY

I. Introduction

1. Macroeconomic policy can have a profound effect on the pace and pattern of economic growth and on the manner in which the growth process shapes the extent and incidence of poverty. But the nature of these effects is poorly understood, because the discourse on macroeconomic policy tends to remain distinct from and parallel to the discourse on poverty. The present report tries to bring these two discourses together in the specific context of Bangladesh. The objective is to identify the salient features of what would constitute a pro-poor macroeconomic policy in Bangladesh.

2. The report begins by providing an overview of poverty and inequality in Bangladesh (Section II) and the structure and sources of growth in the economy (Section III) over the last two decades. By using the insights thus obtained on the dynamics of poverty and growth, Section IV tries to delineate a growth-poverty nexus i.e., the relationship between growth and poverty that has characterised the Bangladesh economy in the recent past. On the basis of an analysis of the nature of this nexus, this section then draws some implications for what would constitute a pro-poor macroeconomic policy regime for Bangladesh. The subsequent chapters then look at specific macroeconomic policies in the light of these considerations. Overall macroeconomic management is discussed in Section V, fiscal policy and public expenditure in Section VI, privatisation and related policies toward state-owned enterprises in Section VII, trade and exchange rate policies in Section VIII, and macro-financial policies in Section IX. Finally, section X provides some concluding observations.

II. Poverty and Inequality in Bangladesh: An Overview

3. The long-term trends in poverty show notable progress since Independence. According to nation-wide Household Income and Expenditure Surveys, the proportion of population living below the poverty line was as high as 71 per cent in 1973/74, the earliest survey year after the country's Independence. By the year 2000, it had come down to 40 per cent. The evidence on long-term decline in income-poverty based on national-level data is also confirmed by a number of longitudinal micro surveys and village studies comparing the situation between late seventies and late nineties

4. The pace of poverty reduction has accelerated in the 1990s compared to the 1980s. Thus, the national head-count ratio dropped only marginally from 52 per cent in 1983/84 to about 50 per cent in 1991/92, but then fell relatively sharply to about 40 per cent by the year 2000. The reduction of poverty that took place in the 1990s – at the rate of about one percentage point per year – was certainly modest by the standards of East and South-East Asia in the last few decades. But at least it marked a welcome acceleration in the pace of poverty reduction compared to the near stagnation of the preceding decade. This acceleration in poverty reduction is consistent with the evidence for accelerated growth in per capita consumption expenditure (income) observed during this period.

5. The progress in non-income dimensions of poverty appears to have been faster than in the income dimension of poverty. The index of human poverty, which stood at 61 per cent in the early eighties, declined to 35 per cent in the late nineties. This gives a drop of 2.5 per cent per year compared with 1.45 per cent in the national head-count ratio for income-poverty over the same period.

6. Faster reduction in poverty in the 1990s has been accompanied by a worsening of income distribution. Thus, the Gini ratio for urban areas shot up from 0.32 in 1991/92 to 0.38 per cent in 2000, while the rural Gini increased from 0.26 to 0.30 during the same period. The main sources of increasing inequality lie in increasingly unequal distribution of non-farm income and remittance income.

III. The Structure and Sources of Growth

7. The economy of Bangladesh experienced moderately accelerated growth in 1990s compared to previous decades. In the 1980s, per capita GDP had grown slowly at the rate of about 1.6 per cent per annum. In the first half of the 1990s, growth rate accelerated to 2.4 per cent and further to 3.6 per cent in the second half of the decade. This was not an insignificant acceleration, even though by no means spectacular by the standards of the rapidly growing countries of the Asia.

8. The acceleration in per capita GDP growth owed itself both to higher rate of GDP growth and a lower rate of population growth, with the former playing the more important role. Thus, out of the 2 percentage points acceleration in per capita income growth that was experienced from the first half of the 80s to the second half of the 90s, as much as 1.5 percentage points came from GDP growth.

9. In the context of the effect of macroeconomic reforms on economic growth, it is interesting to note that the outward-looking macroeconomic policy pursued by Bangladesh in the recent past did succeed in stimulating some parts of the economy (e.g. readymade garments, and fisheries) – so much so that they turned out to be the most rapidly growing activities in the 1990s. But as these activities still have a relatively low weight in the economy, they were by no means the most important sources of growth acceleration.

10. Analysis of the proximate sources of growth shows that industry and services contributed almost equally to the incremental growth in the 1990s, each with a share of about 41 per cent, with agriculture making a relatively small contribution of just 17 per cent. Within the broad group of industry, the manufacturing sub-sector contributed 28 per cent, out of which some 20 per cent came from large and medium industries, and the rest from small-scale industries. In agriculture, fisheries made an overwhelmingly large contribution, accounting for 15 out of the 17 per cent contribution that came from all of agriculture.

11. From the point of view of macroeconomic policy, a pertinent issue concerns the relative roles of tradable and non-tradable sectors in the process of growth acceleration. The report finds that at least two-thirds to three-quarters of the incremental growth in the 1990s originated from the non-tradable sectors – mainly, services, construction and small-scale industry. The increasing dominance of non-tradables in general and services in particular is also confirmed by the evidence on changing composition of labour force.

12. Further analysis shows that acceleration of the non-tradable sector cannot be explained by autonomous productivity improvement within the sector. A more likely explanation lies in a more robust demand stimulus originating from outside the sector, especially in view of the existence of widespread underemployment in this sector, which ought to make it particularly responsive to demand stimulus.

13. Evidence suggests that the demand stimulus came from three major sources – a quantum jump in crop production that occurred in the late 1980s, rapid growth in the flow of income generated by the readymade garments industry, and accelerated flow of workers' remittance from abroad. In relative terms, crop production played by far the major role; even the combined stimulus from the other two sources was less than the stimulus that came from crop production alone. As the decade progressed, readymade garments and remittance began to assume greater importance. But even towards the end of the decade crop production remained the single most important source of enhanced demand.

IV. The Growth-Poverty Nexus and Its Implications for a Pro-Poor Macroeconomic Policy Regime

14. Faster growth in the 1990s was associated with faster rate of poverty reduction compared to the 1980s. There are reasons to believe that this was more than a mere association. Since overall income inequality increased during this period – in both rural and urban areas – faster growth must have played a causal role in reducing poverty. In order to identify the precise nature of this causal relationship, it is necessary to look more closely at the growth process and the nature of the growth-poverty nexus it engendered.

15. It was noted earlier that non-tradable activities, especially those outside agriculture, played the leading role in bringing about accelerated growth in the 1990s. Therefore, the search for the growth-poverty nexus calls for a deeper analysis of the nature of growth in these activities. For this purpose, the report takes a close look at the rural non-farm (RNF) sector in recognition of the fact that most of the poor live in rural areas.

16. A sizeable proportion of rural labour force has shifted from farming to non-farm activities in the last two decades. In 1983/84, some 34 per cent of the rural labour force was engaged in non-farm activities as their principal occupation; by the year 2000 this figure stood at 39 per cent. The pace of the shift from farm to non-farm sector appears to have slowed down somewhat in the 1990s – this was especially true in the first half of the decade.

17. But the more important contrast, for our present purpose, lies in structure of RNF sector. The growth process of 1990s was characterised not only by faster growth of RNF sector but also a structural change in this sector that was especially favourable for poverty reduction. Although there are no systematic surveys of this sector to throw a clear light on how its structure might have changed over time, one can make some reasonable inferences by piecing together a number of different kinds of evidence for the 1980s and the 1990s.

18. For the 1980s, evidence suggests that the increment in landless agricultural households were absorbed almost entirely in the RNF sector. In fact, the size of this increment is large enough to account for the entire shift of labour force out of agriculture that occurred during this period. It would thus appear that the shift of labour out of agriculture could be entirely accounted for by increasing landlessness, and not by increasing number of land-owning households diversifying their sources of income towards non-farm activities. One may conclude, therefore, that this shift has taken place at the lower end of the income scale, since land ownership and income are strongly correlated. This inference is supported by the evidence from Labour Force Surveys and Household Income and Expenditure Surveys, which indicate a proliferation of low-productivity activities within the RNF sector and possibly some overcrowding in these activities.

19. The picture changes quite significantly in the 1990s. Labour Force Surveys show that after being more or less static in the 1980s, the proportion of self-employed workers in the RNF sector declined in the 1990s - from 66 per cent in 1990/91 to 59 per cent in 1995/96. This implies a rise in the proportion of wage-labour based enterprises. Such enterprises are likely to be somewhat larger in scale and more productive than the enterprises involving mainly self-employed workers that predominated in the 1980s. Independent evidence from Household Income and Expenditure Surveys does suggest increasing dominance of larger and more productive non-farm enterprises.

20. Based on these sets of evidence, the transformation that has occurred between the two decades can be summarised as follows. The 1980s were characterised by a rapid shift of labour force into the RNF sector, the predominant nature of the shift being absorption into self-employment at the lower end of the productivity scale. By contrast, the 1990s have witnessed a less rapid shift of labour force into the RNF sector, but one that has been characterised by faster growth of relatively larger-scale enterprises that are more productive and employ more wage labour. The poor rural workers have thus found an increasing opportunity to secure wage employment in the RNF sector instead of overcrowding into petty small-employed activities.

21. This transformation in the dynamics of rural labour force has important implications for the dynamics of poverty in rural Bangladesh. Analysis of the 2000 HES shows that salaried employment in RNF is much more rewarding for the poor than any other mode of employment. For example, the extreme poor working in the rural non-farm sector earned on average *taka* 56 per day from salaried employment as compared with *taka* 38 from self-employed activities. Thus the relative expansion of larger non-farm enterprises allowing for greater absorption of labour into salaried employment may have played a key role in bringing poverty down in the 1990s.

22. The nature of the growth-poverty nexus that operated in the 1990s can now be summarised as follows. Boosted by enhanced demand – emanating initially from the crop sector and increasingly also from the readymade garments and workers’ remittances – the non-tradable non-farm sector experienced accelerated growth in the 1990s. Faster growth enabled the non-farm enterprises to increase their scale of operation, thus tilting the structure of RNF sector more towards the relatively larger enterprises. This structural change in turn brought about a change in the nature of labour absorption in this sector, as salaried wage employment became more plentiful with the emergence of larger enterprises. Whereas in the 1980s most of the surplus labour that got absorbed in the non-farm sector found their way into low-productivity self-employment, in the 1990s the absorption occurred more into salaried employment in the relatively larger and more productive enterprises. Since salaried employment in larger scale enterprises was far more rewarding for the poor than the shift into self-employment that occurred in the 1980s, the structural change engendered by the growth process of the 1990s was especially conducive to poverty reduction.

23. The preceding analysis of the growth and poverty dynamics in the recent decades as well as the analysis of the impediments faced by the poor in taking advantage of economic opportunities opened up by the growth process suggest a policy package that ought to include the following elements.

24. First, since the lynchpin of the growth-poverty nexus was the demand-driven growth of the non-tradable sector, macroeconomic policy must do everything possible to sustain the

momentum of demand expansion, without of course overheating the economy. At the very least, it should avoid unnecessary contraction of demand.

25. Second, the incentive structure promoted by macroeconomic policies should be such as to accelerate the growth of non-tradable non-farm activities, at least over the medium term.

26. Third, conditions should be created that would enable the poor to find more remunerative employment in scaled up enterprises in the non-farm sector. This would in turn require the policy regime to aim at softening at least three types of constraint: (i) education and skill of workers, (ii) physical infrastructure, and (iii) access to credit.

V. Macroeconomic Management in the 1980s and the 1990s: An Overview

28. For much the 1970s, macroeconomic policy was designed in Bangladesh primarily with a view to reviving a war-ravaged economy following the War of Liberation in 1971 within an overall framework of extensive state control. A major change of direction occurred in the early 1980s with the adoption of market-oriented liberalising policy reforms known as structural adjustment. These reforms were initiated against the backdrop of serious macroeconomic imbalances. The beginning of the 1990s saw the launching of a more comprehensive programme of macroeconomic reforms, which coincided with a transition to parliamentary democracy from a semi-autocratic rule.

29. The reforms of the early 1990s were particularly aimed at moving towards an open economy – such as making the currency convertible on the current account, reducing import duties generally to much lower levels, and removing virtually all controls on the movements of foreign private capital. Besides, fiscal reforms were undertaken including the introduction of the value-added tax (VAT).

30. The launching of the wide-ranging policy reforms in the beginning of the 1990s was followed by some positive developments in the macroeconomic indicators. There was a marked improvement in the government's budgetary position along with an equally marked increase in domestic saving rate. However, increase in saving rate was not matched by a commensurate response from private investment, at least in early 1990s. Private investment as a proportion of GDP did go up in the first half of the 1990s as compared with the late 1980s, but not by enough to match the savings effort. Things did begin to change, however, in the second half of the decade when further increase in savings effort was well-matched by increased private investment, while public investment remained more or less stable as a proportion of GDP. As a result, the overall investment rate – which was stuck between 16.5 and 18 per cent during the period from 1985 to 1995 – rose to 21.5 per cent in the second half of the 1990s paving the way for superior growth performance in this decade.

31. All this was achieved along with remarkable success in keeping inflation under control. In the first half of the 1980s, the rate of inflation was ominously high at 13 per cent. It is only the contractionary effect of structural adjustment of that period that brought inflation down – to around 8 per cent in the second half of the decade. The 1990s saw further decline in the inflation rate – down to an average of 5.7 per cent for the decade as a whole, and this time the reduction was achieved despite relative buoyancy of the economy compared to the preceding decade.

32. There are, however, certain disconcerting features in the macroeconomic indicators that deserve attention. First, whenever there seems to be an upturn in investment and industrial activity levels, it comes against the balance of payments constraint leading to a depletion of foreign exchange reserve. Second, the impetus to increased savings rate may have been lost in the recent years with declining public savings. Third, while the reduction of inflation in the 1990s is a positive indicator of macroeconomic stabilisation, there is a danger that the tendency to drive down inflation to near-zero levels would unleash severe contractionary pressures that might stymie the demand-driven process of growth and poverty reduction of the kind that was observed in the 1990s.

VI. Fiscal Policy and Public Expenditure

33. Over the last two decades, fiscal operations of the government had to be defined in the context of a steadily declining availability of foreign aid. The decline has been particularly rapid in the 1990s. From over 5 per cent to GDP in the second half of the 1980s, foreign financing came down to only 2.6 per cent of GDP in the second half of the 1990s.

34. The challenge posed by reduced availability of foreign aid has been met not by reducing expenditure, but partly by improved revenue effort and partly by increased domestic borrowing. Thus, as a proportion of GDP, total government expenditure increased slightly from 12.9 per cent to 13.6 per cent in the last two decades. This was supported by a rising revenue-GDP ratio, which went up from 6.3 per cent in the first half of the 80s to 9.6 per cent in the second half of the 90s, and increased domestic borrowing, which went up from 1 per cent to 1.9 per cent of GDP during the same period.

35. Of the two broad components of government expenditure – current and development – it is the current expenditure that has risen over the last two decades – from 4.6 per cent to 7.3 per cent of GDP. The increase was particularly sharp in the second half of the 1980s (which was the tenure of a semi-autocratic regime). Since then the rise has been much more restrained. The transition to a democratic regime thus seems to have resulted in increased accountability in respect of restraining the government's current expenditures.

36. There are signs that the restraining effect has weakened considerably in the very recent years resulting in a fresh upsurge in current expenditure. However, despite the obvious strains put on the budget by rising current expenditure, the overall budget deficit has not been allowed to get out of control. Indeed the general trend is clearly downward – from around 6.6 per cent of GDP in the early 1980s budget deficit came down to 4.4 per cent in the late 1990s.

37. Overall, these trends indicate that ever since the latter half of the 1980s, fiscal policy has not been used aggressively as a tool of aggregate demand management, in either direction. Fiscal policy thus played the useful role of averting a potential contraction in demand, without however leading to excess demand in the process of doing so. This helped create a reasonably stable macroeconomic environment, which allowed the real side of the economy to sustain modest growth acceleration, leading to reduced poverty, through growth-poverty nexus described above. A sharp rise in budget deficit in recent years (1999/00 - 2000/01) has raised fresh questions about the soundness of macroeconomic management. How these questions are resolved and what effect that resolution will have on aggregate demand may have important repercussions on the dynamics of growth and poverty alleviation in Bangladesh in the coming years.

38. The sectoral allocation pattern of development spending has undergone some significant changes in the last two decades, reflecting the changing developmental role of the government under the economic reforms. Allocations have fallen appreciably for a number of directly productive sectors – most notably, manufacturing industry, water resources, and energy, and agriculture. The reverse of this structural change in development spending is the increased proportional allocations to transport and communication, rural development and to social sectors, especially education.

39. The proportional allocation of education and health has continuously increased all throughout the reform period beginning from the early 1980s. Their combined share of total budgetary expenditure has gone up from 14 per cent to 23 per cent during this period. The increase has been particularly rapid for education, whose share has doubled from 8 per cent to 16 per cent, while the share of health and family planning has increased from 5 per cent to 7 per cent.

40. With considerable progress made in primary education in Bangladesh, the enrolment gap between rich and poor has been considerably narrowed and the gender gap has been eliminated. As a result, public expenditure on primary education is found somewhat pro-poor, in the sense that the poor receive a greater share of the benefit. The food for education programme, which was instituted to entice the parents of poor households to send their children to primary school, has a strongly poor-poor bias.

41. However, this pro-poor bias needs to be put into perspective. The key factor driving the pro-poor distribution of primary education is that the poor have a greater proportion of primary school age children. The rate of per-user subsidy does not actually vary much for different income groups. Furthermore, the pro-poor bias reverses strongly for secondary and tertiary levels of education.

42. Government's overall health expenditures are only weakly pro-poor in the sense that these expenditures were more equitably distributed compared to the distribution of household income or expenditure in the economy. However, one particular component of health spending, namely, child healthcare within the so-called essential services package (ESP) is *strongly* pro-poor (that is, skewed in favour of the poor).

43. On the whole, budgetary allocation to education, health and social safety net as ratios of GDP has increased considerably over the last two decades, and their distribution is also reasonably pro-poor. Unfortunately poor governance severely compromises the potential of social expenditures to serve the poor in the most efficient as well as equitable manner.

44. The main problem, however, is that in per capita terms the level of social expenditure remains very low, even by the standards of other poor countries. Part of the reason why budgetary expenditures are low in absolute terms is that the resource base is low given a low per capita income. But even as a proportion of GDP, budgetary expenditure is low in Bangladesh, even by South Asian standards. Thus, in the year 2000/01, total public expenditure was just 15 per cent of GDP in Bangladesh, as compared with 20 to 30 per cent in India, Pakistan and Sri Lanka.

45. Low level of expenditure is in turn explained by very low revenue effort. An analysis of the trends in tax yields suggest that the tax system is highly income-inelastic, so that the rate

of growth of tax revenue tends to fall behind that of GDP unless discretionary measures are taken for enhancing the rate structure and/or expanding the tax base.

46. Greater effort at resource mobilisation, will, therefore, have to form cornerstone of any strategy to promote pro-poor fiscal policy. While a lot of this effort will involve improvement in institutional and administrative apparatus of tax collection, a number of macroeconomic issues are also relevant in this context and deserve some scrutiny. These are, first, the effect of external sector reforms on tax revenue; second, the size and financing of budget deficit, and third, financing of state-owned enterprises and the related issue of privatisation.

47. Since trade liberalisation entails a potential loss of revenue due to lowering of tariffs, a pertinent question is whether the recent failure to raise revenue efforts in Bangladesh has anything to do with her embracing of trade liberalisation. Data reveal that revenue from import duties has indeed declined as a proportion of total value of imports. However, a great deal of tariff reforms did not lead to any effective reduction in duties, because of widespread prevalence of tariff redundancy. Moreover, any effect of reduced rates of duty was compensated partly by tariffication of quotas and partly by an upsurge in the volume of imports following trade liberalisation, both of which served to expand base of revenue collection. As a result, revenue from import duties as a proportion of GDP did not decline. In addition, introduction of VAT, on domestic and imported goods alike, enabled the government to recoup much of what was lost by way of customs duties, and it did so in an incentive-neutral manner.

48. As a result of these reforms, overall collection of indirect taxes did not suffer in Bangladesh following trade liberalisation. As a proportion of GDP, total revenue from indirect taxes actually increased from 4.6 per cent in late 1980s to 6.3 per cent in the second half of 1990s. Therefore, the reason for poor revenue effort lies not so much in trade liberalisation as in government's inability to collect domestic taxes.

49. Inadequate success in domestic revenue mobilisation, coupled with declining foreign aid, has put enormous pressure on public finances. Given the choice between cutting down public expenditure and allowing the budget deficit to increase, the Government has on the whole opted for the latter. However, for most of the last two decades, budget deficit has generally been kept low, and so has been public debt. In very recent years, however, as foreign aid has declined even more, budget deficit grown bigger – rising from 4 per cent to about 6 per cent of GDP. This upsurge in budget deficit has rung an alarm bell in the donor community, who are advocating stringent measures to bring the deficit down.

50. This report argues that excessive worry on the part of donors such as the World Bank and the Asian Development Bank with current levels of deficit is unwarranted, as their arguments are based on untenable assumptions and flawed methodology. The point remains, however, that there are limits to how far budget deficit can be allowed to grow. Occasional deficit may be necessary as a counter cyclical measure, and also to break crucial bottlenecks on the supply side through judicious public investment. But it cannot be used as a regular tool for raising the trend level of public expenditure. In the long run, revenue collection must be improved, and expenditure must be prioritised. In this context, the financing of loss-making state-owned enterprises assumes special relevance. This issue is taken up next.

VII. Privatisation and Related Policies toward State-Owned Enterprises

51. In Bangladesh, the predominant method of privatisation has been divestiture – mostly sale through tender, although the Privatisation Policy of 2001 allows for other forms of privatisation, such as sale through capital market, management contracts, leasing, and liquidation. Almost all divestitures comprised industrial units, especially jute and textile mills, except for two public banks.

52. Privatisation in the 1980s had been most extensive and outstandingly rapid in comparison to the process in the 1990s. The share of the public sector in total industrial assets was more than halved during 1982 to 1986 through the transfer of public industrial and commercial enterprises to the private sector. The pace of this process significantly slowed down in the late 1980s and during the 1990s. Between 1988 and 1999, only 29 enterprises were divested either wholesale or partially as opposed to more than 650 enterprises divested/denationalised during 1982-1986.

53. The Privatisation Policy of 2001 outlines the main objectives of privatisation in Bangladesh as follows:

- a) Increasing social welfare through efficiency gains.
- b) Attracting foreign investment.
- c) Receipt of revenue through divestment.
- d) Release of the revenues from loss making enterprises for other social needs.
- e) Protecting and promoting employment opportunities by promoting competitiveness.

54. However, there is limited information and knowledge about various dimensions of social impact of privatisation. Although all of the main objectives given above are related to revenue generation and its use for social purposes, the data on divestment revenues and how they are used is rather patchy and in many cases absent. Official estimates of divestment revenues for the last two decades show that gross revenue generation has been rather dismal throughout the period. In most years, gross revenue generated was well below one per cent of total government expenditure. Only in a few of years did the proportion rise above one per cent – e.g. 1.5 per cent in 1983 and 1.1 per cent in 1993.

55. The primary rationale for reforms of the SOEs in general, and for privatisation in particular, lies in their weak financial performance. The same is true for Bangladesh. All indicators suggest that the financial performance of SOEs has deteriorated noticeably in recent years. For example, their contribution to GDP, which averaged about 2 per cent of GDP over the mid-1990s, has declined to less than 1 per cent in recent years. And, as a proportion of operating revenues, their value-added has come down from around 25 per cent to about 10 per cent during the 1990s.

56. The inability of SOEs to generate internal surplus has resulted in large budget deficits. Defining the SOEs' budget deficit in a manner analogous to that of central government's budget deficit, it is found that gross SOE deficit has increased from less than 2 per cent of GDP in the second half of the 1990s to an average of 2.6 per cent during 1999/00-2001/02.

57. Since, by far the major part of SOE deficit is financed directly by the government budget, the financial losses of SOEs account for a significant part of the strain on government budget. By serving to raise the overall budget deficit of the government, SOE losses are thus creating pressure to cut down expenditure on other sectors. These losses, therefore, involve a

significant opportunity cost in terms of foregone spending on other sectors. During the period 1991/92-2001/02, for example, gross losses of SOEs (defined as total losses of all loss-making enterprises) were on the average equivalent to 30 per cent of annual budgetary spending on health and education.

58. In spite of the palpably adverse impact of loss-making SOEs on public finances, privatisation is often resisted on other grounds. It has been noted, for example, that privatised enterprises are not necessarily more efficient than the SOEs in Bangladesh. But this argument ignores the point that if the enterprises remain inefficient even after privatisation, they will have to go out of business (unless of course the government props them up through artificial means). And inefficient firms going out of business is part of the process of gaining overall efficiency.

59. Privatisation is often resisted on equity grounds, and at times described as positively anti-poor – for retrenchment of workforce that typically accompanies privatisation and for loss of subsidies that are sometimes offered through pricing policy of SOEs. In reality, however, retrenchment of labour is a consequence of unsustainable overstaffing that has historically plagued most of the SOEs rather than of privatisation as such. Moreover, majority of workers who have been retrenched following privatisation in Bangladesh do not in fact belong to the category of poor, as normally defined. Besides, a proper compensation and retraining policy can in principle mitigate the short-term pain that retrenchment inevitably entails. As for the argument based on loss of subsidy, evidence suggests that most of the subsidies offered by SOEs in Bangladesh do not in fact have a pro-poor bias, so that the loss of subsidies cannot in general be described as anti-poor.

60. Thus neither on efficiency nor on equity ground can one make a strong case against privatising perennially loss-making SOEs. On the contrary, in view of the fact that budgetary burden of these losses inhibits increased allocation to social sectors, one may even argue that privatisation can be rendered compatible with a pro-poor macroeconomic policy in Bangladesh by ensuring that resources saved through privatisation are actually utilised for pro-poor expenditure and that adequate compensation is paid to poor retrenched workers.

VIII. External Sector Policies

61. Trade liberalisation effort started in mid-1980s and already by the end of the decade Bangladesh had moved from initial phase of removal of quota restrictions to that of tariff reductions. In the initial stage, substantial trade liberalisation occurred mainly in agriculture, liberalisation of industry came somewhat later.

62. In the mid-1980s, agricultural liberalisation took the form of removing non-tariff barriers on the import of irrigation equipment. The salutary effect this has had on poverty in the 1990s, by spurring agricultural growth, which was the primary source of demand stimulus to non-farm sector, has been discussed in Sections III and IV of this report. A second wave of agricultural liberalisation came in the 1990s when state monopoly on the import of rice was ended and private traders were allowed to enter the business. The benefit of this policy was evident following the devastating floods of 1998. Private traders promptly responded to the crisis by importing huge quantities of rice from India and the prices soon stabilised, as the import parity price of Indian rice acted as a ceiling on the price of domestic rice. Much hardship of the poor was avoided as a result.

63. The liberalisation of industrial products began in the late 1980s with the removal of import controls, which resulted in the elimination of the very high scarcity premia that had characterised the earlier trade regime. New rounds of trade reforms were undertaken in the early 1990s, with the objective of reducing import tariffs to significantly lower and more uniform levels.

64. Starting from the withdrawal of quota restrictions in the late 1980s to tariff reductions in the first half of the 1990s, Bangladesh has had one of the most rapid episode of import liberalisation compared to other countries during their similar period trade reforms. Yet at the end of this period, Bangladesh still remained relatively "closed" in terms of the extent or depth of liberalisation. Besides, the pace of liberalisation has slowed down considerably since the mid-1990.

65. While the extent and speed of further import liberalization remain a contentious issue, it must be recognised that a general reversal is not on the agenda, since the incentive structure still retains a bias against the exportables. However, the patterns of liberalization and its sector-specific impact – i.e., the *de facto* elements of an 'industrial policy' implicit in trade reforms – need scrutiny from the point of view of pro-poor growth.

66. For example, an important effect of the tariff reforms has been to stifle the growth of domestic engineering and capital goods industry. This adverse effect of import liberalisation has been discounted because of the rather small size of this industry and because the removal of duties on machinery imports has been a means of providing incentives for other industries. This ignores the potential role of a domestic capital goods industry in technological adaptation, which is especially important for upgrading the traditional technology in the informal sector and for facilitating sub-contracting arrangements with large-scale firms. Moreover, there are certain anomalies in the tariff structure that discriminate against the informal sector. For example, compared to machinery and industrial inputs used in large-scale manufacturing, items like sewing machine and small hand tools are taxed highly, perhaps because of their part use as consumer items. The potentially adverse consequences all this has for the small and medium enterprises can jeopardise the cause of poverty reduction, considering the pivotal role such enterprises have played in the growth-poverty nexus described in section IV.

67. An important aspect of liberalisation concerns the potential impact of accession to WTO, of which Bangladesh has been an early member. Specifically, the impact on agriculture and readymade garments has been much discussed in this context. It appears that successive structural adjustment programmes over the last two decades have resulted in such a rapid elimination of agricultural subsidies that Bangladesh already satisfies. WTO stipulations regarding permissible levels of support to agriculture, as a result, joining of WTO does not entail any reduction of incentive for Bangladesh agriculture. To that extent, there is no reason to expect any dampening, on account of WTO, of the poverty-reducing effect generated by agriculture in the recent past.

68. The prospects for readymade garments are much more uncertain, however, as the protective umbrella of Multi-Fibre Agreement (MFA) comes to an end by the year 2005. In order to be able to compete successfully in the post-MFA era, the garments industry of Bangladesh will have to take measures to improve its productivity and diversify into higher value-added products. How successfully these structural changes are accomplished will have a significant impact on the poverty front as well, since the growth of garments industry has

played an important role – both directly and indirectly – in alleviating poverty in Bangladesh in the last decade.

69. The effect of trade liberalisation needs to be examined along with that of the accompanying flexible exchange rate policy. A remarkable aspect of Bangladesh's experience in this respect is that in spite of substantial trade liberalisation taking place at a time of a marked and steady decline in external deficits, the extent of real devaluation of *taka* was much less compared to many developing countries undergoing similar trade reforms. The available estimates suggest that the extent of real devaluation since the late 1980s to mid 1990s was no more than 12 to 15 percent; the process was reversed in the later half of the 1990s when *taka* actually appreciated compared to the beginning of the 1990s.

70. These trends in real exchange rate have put Bangladesh at a disadvantage in export competition with the other developing countries and in promoting an export market within these countries, especially the neighbouring ones. Nevertheless, aggressive devaluation, as advocated by some proponents of export-led growth, is not much of an option since the exchange rate is already flexibly managed in view of the current account convertibility of the currency. In any case, judging by the negligible size of the premium in the secondary market, the official exchange rate cannot be far from its equilibrium level.

71. More importantly, by tilting the structure of incentives against the non-tradables, devaluation is likely to damage the very segments of the economy that has played the most pivotal role in the growth-poverty nexus in the last decade. There is an important trade-off here. Real depreciation will presumably promote exports and thereby promote employment and poverty alleviation by encouraging labour-intensive export-oriented industries. On the other hand, it will hamper poverty alleviation by going against the non-tradables. The resolution of this trade-off probably lies in avoiding aggressive devaluation combined with the adoption of specialised measures to promote exports.

IX. Macro-Financial Policies

72. Bangladesh's financial reforms started in the early 1980s by allowing commercial banks to be set up in the private sector. The second aspect of the reform was to gradually liberalise the interest rates from the early 1990s. The new liberalized system is based on the hypothesis that depositors can get a fair return and credit can be allocated more efficiently through market-determined interest rates. The actual results of financial liberalisation were, however, far from those envisaged. One main reason for this was that Bangladesh went for financial liberalisation without providing for adequate regulation and supervision.

73. The private banks were also infected with the widespread culture of loan default plaguing the public sector banks, although the reason for this malaise in the two cases was not the same. Excessive loan default has resulted in high costs of financial mediation as reflected in the very large spread between the deposit and lending rates of interest (currently as high as about 7%). As a result, the interest spread has actually increased rather than decreasing through market competition, while the relatively efficient private banks, including the foreign ones, reaped excess profits. The resulting high cost of borrowing not only tends to depress private investment, it also makes puts strain on government budget by making it harder to maintain any given level of budget deficit.

74. Besides, the proportionate share of annual bank advances going to agriculture and small and cottage industries has significantly declined following financial liberalisation, while large-scale manufacturing has been able to hold its ground. This does not mean that the previous system of directed or subsidized credit allocations was either efficient or equitable. What it does mean is that the reforms towards financial liberalisation have had little to do with the problem of providing access to credit to those sectors or activities that are most starved of credit.

75. Nor has liberalisation done much to help the so-called ‘missing middle’ – the medium sized enterprises that are mostly bypassed both by the formal credit sector, which tends to concentrate on big clients and by the micro-credit programmes, which cater to the very small. The pioneers of the micro-credit movement are now experimenting with innovative mechanisms for meeting the needs of the ‘middle poor’ and ‘vulnerable non-poor’ through micro-enterprise loans. This will involve both scaling up of micro-credit operations and diversification into a wider range of micro-finance activities, including deposit mobilisation, small-scale insurance, and so on. This in turn will require a legal and institutional framework for prudential supervision of micro-finance institutions (MFI). Such a framework has yet to be developed, but efforts are being made to develop one. Success of these efforts will have an important bearing on pro-poor growth, in view of the crucial role played by the medium and small-scale enterprises in the process of poverty reduction in the last decade.

X. Concluding Observations

76. The central message of this report is that in order to be pro-poor the incentive structure generated by macroeconomic policy in Bangladesh must strike a balance between tradables and non-tradables. Blanket recommendation to give priority to tradables under all circumstances – a tendency often observed in current orthodoxy in macroeconomic policy – may not be justified.

77. It is conceivable, however, that over time tradable sector will have to become driving force in Bangladesh. As underemployment in non-tradable sector goes down, multiplier effect of a demand stimulus originating from agriculture will weaken, even assuming that future productivity growth in agriculture will continue to offer the stimulus. At that point, the tradable sector will have to take over.

78. This transition from non-tradable-based to tradable-based pro-poor growth will have to be carefully managed. Macroeconomic policy will have to play a big role here. The salient lessons for pro-poor macroeconomic policies that emerge from the analysis presented in this report include the following.

- Unduly conservative attitude towards aggregate demand management must be avoided. While budget deficit and inflation must not be allowed to get out of control, occasional blips in deficits should not be allowed to be an excuse for clamping down with a contractionary policy. Otherwise, the demand-driven pattern of growth that has succeeded in reducing poverty in the last decade will come to a halt, to the detriment of the poor.
- Real exchange rate must be kept close to equilibrium, so as not to discourage exports. However, aggressive devaluation must not be allowed to push Real Effective Exchange Rate (REER) below equilibrium – not only because it is inimical to static efficiency but more importantly because it will militate against pro-poor growth based on non-tradables.

- Financial sector must be reformed so as to bring the real interest rate down. This will help poverty alleviation both directly – through credit availability – and indirectly – through enlarging the margin of sustainable budget deficit, especially in a situation where revenue collection remains weak. Loan default must be tackled head on. At the same time, innovative mechanism must be found to make credit available to the ‘missing middle’.
- While tariff reduction and trade liberalisation has moved in the right direction, details of the tariff structure must be determined on the basis of a well thought out industrial policy. Incentive must be provided for small tools manufacturing, in particular, and capital goods sector, in general.
- The poor must be equipped with adequate human capital, especially in terms of education and health, if they are to take advantage of the opportunities to be opened up by pro-poor macroeconomic policy. Bangladesh has made considerable progress in this regard, but there is still a long way to go. Budgetary spending on social sectors must, therefore, be increased.
- Since overall availability of resources rather than sectoral allocation is the binding constraint on raising the level of expenditure on social sectors, every possible means must be explored to raise or save additional resources, especially in view of declining foreign aid. Politically motivated upsurges in current expenditure must be avoided. Wastage in the use of public resources must be eliminated, and inefficiency of state-owned enterprises must be tackled head on, with a range of actions that could also include privatisation as an option.

I. INTRODUCTION

Macroeconomics, by its very nature, deals with economic aggregates, and evaluation of macroeconomic policy is typically done in terms of aggregate economic balances, such as internal and external balance. The impact of macroeconomic policy, however, goes far beyond these aggregate balances, to touch the lives of individual persons through a variety of pathways. In particular, macroeconomic policy can have a profound effect on the pace and pattern of economic growth and on the manner in which the growth process shapes the extent and incidence of poverty. But the nature of these effects is poorly understood, because the discourse on macroeconomic policy tends to remain distinct from and parallel to the discourse on poverty. There is a need to bring these two discourses together. The present report tries to do so in the specific context of Bangladesh. The objective is to identify the salient features of what would constitute pro-poor macroeconomic policy in Bangladesh.

The report begins by providing an overview of poverty and inequality in Bangladesh (Section II) and the structure and sources of growth in the economy (Section III) over the last two decades. By using the insights thus obtained on the dynamics of poverty and growth, Section IV tries to delineate a growth-poverty nexus i.e., the relationship between growth and poverty that has characterised the Bangladesh economy in the recent past. On the basis of an analysis of the nature of this nexus, this section then draws some implications for what would constitute a pro-poor macroeconomic policy regime for Bangladesh.

The subsequent chapters then look at specific macroeconomic policies in the light of these considerations. Overall macroeconomic management is discussed in Section V, fiscal policy and public expenditure in Section VI, privatisation and related policies toward state-owned enterprises in Section VII, trade and exchange rate policies in Section VIII, and macro-financial policies in Section IX. Finally, section X provides some concluding observations.

II. POVERTY AND INEQUALITY IN BANGLADESH: AN OVERVIEW

II.1 Trends in Income Poverty

Methodology of Poverty Estimation

It is important to acknowledge at the outset that there is no consensus on the prevalence of poverty in Bangladesh – instead, a range of estimates are available. The variations are attributable to differences in assumptions relating to minimum calorie requirement for survival, items included in the minimum diet, choice of prices used to convert the normative minimum food consumption bundle into a “food poverty line”, and the choice of adult equivalence in estimating total household calorie requirement. Two methodological issues are especially important in the context of Bangladesh.

First, there is some debate as to whether the calorie norm currently adopted for Bangladesh is appropriate to the need of the population. Bangladesh Nutritional Council proposed a higher calorie norm of 2280 calories with considerably higher allowance for protein and micronutrient requirements (BIDS 2001). On the other hand, there is some evidence that Bangladesh’s calorie norm is higher than those adopted for other South Asian countries, as a result of which poverty is “overestimated” in Bangladesh vis-à-vis its neighbours (World Bank 2002a). There is also the added consideration that the ‘activity mix’ at the national level has changed considerably over time, especially with the rise of urban population from 5 per cent in the mid-seventies to 24 per cent in the late nineties. Besides, tastes and preferences have also undergone considerable changes over time. All these entail the need for re-visiting the national age-sex-activity-adjusted calorie norm itself, which has remained unchanged over the last two and a half decades. Depending on whether this will lead to upward or downward revision of the calorie norm for the recent period, the poverty rates and trends will vary.

Second, most poverty comparisons do not take into account non-market access to public (social) services (Deaton 2001). Given the rising prominence of social sectors in public budgetary allocations since the early nineties and wider coverage of public education and health services among the population, this consideration needs to be factored into income-poverty calculations. The pace of income poverty reduction in the nineties will vary considerably once these “transfers” are appropriately apportioned to the various social groups. Some preliminary studies on the benefit incidence of public health and education spending at the primary and secondary levels indicates considerable “pro-poor” nature, while those spent at the tertiary level exhibit “anti-poor” tendencies.¹ Much would depend on the balance of these two tendencies.

There is no universal standard or consensus on the measurement choices, however. Building on the recent insights of the poverty measurement literature, the present report maintains that it is important to keep the real value of the base year poverty line fixed for the sake of comparability of poverty numbers across time and over relevant spatial dimensions.² This report uses the Cost-of Basic-Needs (CBN) method for setting the ‘food poverty line’, which is based on the costing of a given fixed bundle consisting of normative food items corresponding to the age-sex-activity-adjusted standard of 2112 calories per person per day. This calorie norm is typically used in the Bangladesh literature and has been defended as a

¹ Evidence for these tendencies are discussed in Section VI of this report.

² For an earlier application along this line, see Ravallion and Sen (1996).

national derivative of the “modified FAO standard for South Asia” (Ahmad and Hossain 1984; Muqtada 1986). Prices used for costing the normative food bundle have been derived from available Household Income and Expenditure Survey (HIES) data on the consumption of goods in quantities and values. The costing of the fixed food bundle is done for each of the survey year separately. In the absence of a theoretically justifiable norm, the base year ‘non-food poverty line’ is derived empirically. It corresponds to the actual non-food (private) expenditures incurred by the households located at the food poverty line (in practice, within 5-10% range of the food poverty line). The base-year non-food poverty line (as derived for the 1983/84) is updated for the subsequent years by applying the average cost of living index for the non-food items (as separate cost of living index is not available for the poor households in rural and urban areas). The total poverty line is the sum of the food and the non-food poverty lines. Once the poverty line is derived, the corresponding poverty rates are calculated for the rural and urban areas separately with due accounting of the underlying cost of living differences, while the national estimates represent the population-weighted averages of rural and urban estimates.

The poverty estimates use consumption expenditure data as the measure of income with the implicit assumption that current consumption would be a better indicator of permanent income status in the context of an agricultural society that is subject to year-to-year fluctuations in the output. Since the access to unit record data – the preferred data set for estimating any distributional measure – is not available for all the survey years, the present estimates are based on grouped data. Per capita (and, *not* per household) consumption expenditure has been considered as the appropriate variable for expenditure ranking of households, while the distribution of population (and, *not* of household) has been considered as the more relevant counting variable.

Aggregate Trends

Trends of poverty, estimated on the basis of the preceding methodology, are reported in Table II.1. Several features of the trend are noteworthy.

First, the long-term trends in poverty show notable progress since Independence. The proportion of population living below the poverty line was as high as 71 per cent in 1973/74, the earliest survey year after the country’s Independence. The corresponding indicator for 2000 – the latest survey year – stands at 40 per cent.³ This gives a long-term poverty reduction rate of 1.65 per cent per year. While this rate is considerably lower than rates observed in high-performing economies of East and South-East Asia, it was a commendable achievement, after decades of slow economic growth and rising poverty levels. The evidence on long-term decline in income-poverty based on HIES data is also confirmed by several longitudinal micro surveys and village studies comparing the situation between late seventies and late nineties (Westergaard and Hossain 2000; Siddiqui 2000; Greeley 1999) and comparing the situation between mid-eighties and late nineties (Hossain *et al.* 2002).

³ The national poverty estimate for 1973/74 is the population weighted average of the past estimates for rural and urban areas. The incidence of poverty for that year was calculated to be 71.3 per cent for rural areas (Hossain and Sen 1992) and 63.2 per cent for urban areas (Sen and Islam 1993). The 1973/74 figure is not strictly comparable with the surveys done since the early eighties because of shift in the survey methodology beginning with 1983/84 (on this see, Khan 1990; Ravallion 1990; Osmani 1990). However, the underlying trends of considerable decline between the early seventies and late nineties appear credible.

Table II.1

Trends in Poverty: Consumption Expenditure Data

	1983/84	1988/89	1991/92	2000
Rural				
H	53.8	49.7	52.9	43.6
P(1)	15.0	13.1	14.6	11.3
P(2)	5.9	4.8	5.6	4.0
Urban				
H	40.9	35.9	33.6	26.4
P(1)	11.4	8.7	8.4	6.7
P(2)	4.4	2.8	2.8	2.3
National				
H	52.3	47.8	49.7	39.8
P(1)	14.5	12.5	13.6	10.3
P(2)	5.7	4.6	5.1	3.6

Note: National poverty estimates are population-weighted poverty measures obtained separately for rural and urban sectors. The rural population shares are 88.7% (1983/84), 86.6% (1988/89), 83.4% (1991/92), and 78% (2000).

Source: Estimated from Household Income and Expenditure Survey, various years.

Second, the poverty trends for the eighties are marked by considerable instability. The national head-count ratio declined between 1983/84 and 1988/89, but increased in the subsequent years.⁴ This trend is, however, valid only for rural areas. In urban areas, poverty declined secularly.

Third, there has been faster progress in poverty reduction during the nineties compared with the eighties. Thus, national head-count ratio dropped only marginally from 52 per cent in 1983/84 to about 50 per cent in 1991/92, but then fell relatively sharply to about 40 per cent by the year 2000. The reduction of poverty that took place in the 1990s – at the rate of about one percentage point per year – was certainly modest by the standards of East and South-East Asia in the last few decades. But at least it marked a welcome acceleration in the pace of poverty reduction compared to the near stagnation of the preceding decade. This acceleration in poverty reduction is consistent with the evidence for accelerated growth in per capita consumption expenditure (income) observed during this period.⁵

⁴The paper has deliberately excluded the estimates for 1985/86 and 1995/96 as concerns have been raised about the validity of these estimates. Ravallion (1990) found that the observed decline in poverty between 1983/84 and 1985/86 does not match consumption measures obtained from national income accounts. This is particularly true for the rural areas. Agricultural GDP, which was growing at a rate of 5 per cent in 1983/84, declined to 3.3 per cent in 1985/86. The overall expansion of agricultural GDP was 2.1 per cent per annum during 1984-86, which was considerably below the population growth of 2.6-2.8 per cent during the period. World Bank (1999c) also holds the view that "the survey suffers from lower quality data than were available in other years" (p. 6). Similarly, concerns have been raised about the validity of the 1995/96 urban poverty estimates (see, Khan and Sen 2001 expressing doubt on the reliability of the urban growth data between 1991/92 and 1995/96, and GOB (2003) and World Bank (2002a) on the underlying urban poverty trends).

⁵Thus, the annual per capita HIES consumption expenditure growth at national level, which was just 0.6 per cent during the period between 1983/84 and 1991/92, rose to 2.7 per cent between 1991/92 and 2000. It may be noted that the annual growth in per capita GDP was around 1.5 per cent during the eighties, but nearly doubled during the nineties. The pace and structure of growth in Bangladesh is discussed more fully in Section III below.

Fourth, between 1983/84 and 2000, the pace of poverty reduction was faster in urban areas (2.2 per cent per year) compared with rural areas (1.2 per cent per year), but there has been considerable acceleration in the reduction of rural poverty in the nineties. As a result, the gap between urban and rural poverty reduction rate has narrowed down considerably in the recent years.

Fifth, the poverty trends are robust to the choice of poverty measures. Trends in the more distributionally sensitive poverty measures such as poverty gap index and squared poverty gap index closely tracks the movement in the head-count ratio. However, unidirectionality in the movement of the Foster-Gree-Thorbeck (FGT) class of poverty measures does not mean that the hardcore poverty phenomenon does not have any special significance any more in the Bangladesh context. Income (consumption) differentials between the poor and the poorest constitute an important aspect of the poverty reality in Bangladesh. The estimate can vary depending on the definition of 'extreme poverty'. About 45 per cent of the poor in 2000 lived in extreme poverty (defined as living below 1800 kcal as per the direct calorie measure). The proportion would rise to 68 per cent if one defines 'very poor' as per the 'lower poverty line' adopted by World Bank (2002a).

The progress in attacking incidence of extreme poverty has not been satisfactory. Several layers of economic and social deprivations can be identified within the broad rubric of extreme poverty. The latter includes a heterogeneous mix of identities, including elderly poor, disabled people, the child-headed households, the female destitute households, the people without homestead, socially marginalised ethnicities, deprived castes, and those engaged in dying occupational groups, to name a few. Multiple and overlapping vulnerabilities such as the longer duration in poverty, often spanning generations, adverse interplay between vulnerable ecology and chronic social disadvantages, and very high level of consumption short-falls and high food insecurity (with frequent exposure to starvation) make compelling case for giving priority to extreme poor in designing social policy agenda.

Spatial Variation in Poverty

Average progress conceals considerable spatial variation. The pace of poverty reduction over the entire decade of nineties has been unequal across regions, with rapid progress in Dhaka division and very little change in the eastern region Chittagong (inclusive of Sylhet) division. The spatial differences in poverty levels are also striking. The recent round of the HIES data for 2000 carried out by BBS (2001b) sheds light on this. The incidence of national poverty appears to be the highest in the western region Rajshahi (61 per cent), much higher than the southern region Barisal (40 per cent) and central region Dhaka (45 per cent). This is followed by the eastern region Chittagong (48 per cent) and the south-western Region Khulna (51 per cent). There is considerable district-level variation in poverty, as suggested by the spatial variation in agricultural wage data as well as various indicators of social deprivations such as illiteracy and child mortality.

Task Forces (1991b) and BIDS (2001) have attempted to construct a spatial poverty map, which indicates pockets of severe distress in unfavourable agro-ecological environments, especially in low-lying districts with vulnerability to river erosions. There is a considerable interface between the persistence of chronic poverty and unfavourable agricultural environments (e.g. salinity-prone, flood-prone, river-erosion prone, drought-prone areas). Poverty and social deprivations tend to be higher in the case of the tribal people of the Chittagong Hill Tracts (CHT) and other parts of the country (Rafi and Chowdhury 2001).

Relative Progress of Income and Non-Income Dimensions of Poverty

It is interesting to note that the progress in non-income dimensions of poverty appears to have been faster than in the income dimension of poverty. The index of human poverty, which stood at 61 per cent in the early eighties, declined to 35 per cent in the late nineties. This gives a drop of 2.5 per cent per year compared with 1.45 per cent in the national head-count ratio for income-poverty over the same period. However, to the extent that the accumulation of social factors created over the past two decades serves as “initial condition” for subsequent income growth, the pace of income poverty reduction can be expected to be higher in the coming decades.

The nexus between initial social conditions and subsequent economic growth and income poverty reduction would of course be shaped by the extent of inequality in the initial social conditions, especially asset inequality. This is because social investments can have stronger effects on income poverty reduction under conditions of lower initial level of asset inequality.⁶ For this reason, the future of poverty dynamics cannot be premised on the growth considerations alone. More explicit weighing of the question of income inequality as a factor influencing the pace of poverty reduction is necessary. This is attempted in the next section.

II.2 Trends in Income Inequality

Income inequality can influence the pace of poverty reduction through two major channels. The first channel works through the mechanism of “initial inequality”. The second channel operates through the mechanism of “contemporaneous changes in income inequality”.⁷ Note that asset is used here in the broadest sense (as defined in the “livelihoods” framework) and captures the availability of physical, human, financial, natural, social and political assets. In most empirical practices, however, asset inequality is proxied by the level of income (consumption expenditure) inequality.

The first channel shows that lower initial asset (income) equality is doubly beneficial for income poverty reduction. It not only increases the aggregate rate of subsequent income growth, but also enhances poverty responsiveness of growth itself. The second channel shows that when economic growth is accompanied by rising income inequality, opportunities are missed for poverty reduction. This is captured by decomposing changes in poverty measures into “growth” (often termed as the “growth elasticity”) and “inequality” components (often termed as the “inequality elasticity”). The inequality component will capture the extent of poverty reduction not taken place because of adverse effects of inequality. For example, had growth in Bangladesh been distributionally neutral, the head-count index of rural poverty would have declined by 2.4 percentage points instead of 0.9 actually observed between 1983/84 and 1991/92. Similarly, the incidence of urban poverty would have dropped by additional 10.8 percentage points instead of 7.3 during that period (Ravallion and Sen 1996). Analysis of similar nature with more recent data shows that worsening income distribution during 1990s reduced the extent of poverty reduction. Had the observed rate of growth during

⁶High income/ wealth inequality in the context of credit market imperfections can reduce the level of private investment in human capital and dampen the future productivity and economic growth (Galor and Zeira 1993; Banerjee and Newman 1993). There is considerable cross-country evidence to suggest that the slope of the relationship between social investments and the pace of income poverty reduction tends to be particularly steep at low levels of income (see, for instance, Anand and Ravallion 1993).

⁷There is considerable literature on these two channels. See, for instance, Ravallion (1997) and Kakwani (2000) for statistical properties of egalitarian growth and its likely impact on poverty reduction. The channels of growth, inequality, and poverty are extensively discussed in Osmani (2000).

the period between 1991/92 and 2000 been distribution neutral, poverty would have fallen by 17 percentage points, or almost twice the actual observed rate (World Bank 2002a). In short, with lower inequality elasticity it is possible to achieve the same quantum reduction in poverty with lower aggregate growth rate in income.

During the earlier surveys up to 1991/92, level of consumption expenditure inequality did not vary much: the urban Gini hovered around 0.30-0.32, while the rural Gini fluctuated in and around 0.25-0.26 per cent (Table II.2). The situation has changed in a major way since the early nineties. The increase in inequality was sharp on a scale not seen before. Thus, the Gini coefficient for urban areas shot up to 0.38 in 2000, rising from 0.32 in 1991/92. Similarly, the rural Gini rose to 0.30, up from 0.26 during the same period. While international comparison of Gini index is subject to many problems, it is fair to conclude that Bangladesh has entered the stage of relatively high-income inequality, which is increasing over time – it would appear that Bangladesh is currently riding on rising part of the Kuznet’s curve.⁸

A sharp rise in inequality possibly would not be worrying in the context of rapid economic growth and structural change about which Kuznets wrote decades earlier. Evidently, this has not been the Bangladesh experience during the early nineties, which witnessed a pronounced increase in inequality in the backdrop of a fairly modest rate of economic expansion.

The analysis based on the ‘growth incidence curve’ shows that growth in rural areas was relatively broad-based while urban growth mainly benefited the relatively affluent (World Bank 2002). Even though average growth in mean per capita expenditures over the nineties was lower in rural areas than urban areas (1.7 per cent vs. 2.3 per cent per year), it was more evenly distributed across different expenditure groups. In contrast to the rural areas, the difference in growth rates across the income distribution in urban areas is striking: the average growth rate for the bottom 20 per cent was less than one-third the rate for the top 20 per cent of the urban population (0.8 per cent vs. 2.9 per cent per year).

Table II.2
Summary Statistics on Growth and Inequality: Consumption Data
(Tk/month/person)

	<i>Poverty Line</i>	National Survey Mean	Mean/ Poverty Line	Gini Index
Urban:				
1983/84	301.72	396.53	131	0.298
1988/89	453.65	695.19	153	0.326
1991/92	534.99	817.12	153	0.319
2000	724.56	1430.12	197	0.379
Rural:				
1983/84	268.92	284.84	106	0.246
1988/89	379.08	435.39	115	0.265
1991/92	469.13	509.67	109	0.255
2000	634.48	820.20	129	0.297

Source: Estimated from Household Income and Expenditure Surveys, various years.

⁸Although the general validity of the Kuznets process has not been borne out by recent cross-country experience (Fields 1989; Anand and Kanbur 1993; Deininger and Squire 1996; Bruno et al 1998), this does not mean that the process cannot be valid for a specific country for a specific period.

It should be noted, however, that consumption data understates the degree of relative inequality prevailing in the society. One needs to consider the distribution of income and wealth as well. The wealth data are, however, difficult to come by, but we have access to information on current income distribution. Analysis of current income distribution further confirms the increasing trend in relative inequality. The Gini index for rural income inequality rose sharply from 0.27 in 1991/92 to 0.31 in 1995/96, rising further to 0.36 in 2000. The corresponding rise in urban income inequality during the nineties is even more striking, urban Gini having increased from 0.33 in 1991/92 to 0.39 in 1995/96, increasing subsequently to 0.44 per cent in 2000.⁹

II.3 Sources of Changes in Income Inequality

The problem of increasing inequality assumes special significance in a situation where the very process that brings some initial dynamism in the system also contains factors that lead to sharp deterioration in income distribution. This can be judged by analyzing the sources of rising inequality, as actually observed between 1991/92 and 2000. Some growth-seeking sources have become prominently disequalising while some of the equalizing sources of income have apparently lost past growth momentum, as their share in total income have gradually declined.

Unpacking the Deterioration in Income Distribution

Table II.3 presents information on the sources of inequality in rural Bangladesh.¹⁰ Activities that are intensive in financial capital (such as trade and many non-farm self-employment activities requiring considerable injection of capital), income sources associated with human capital (such as salaried wage employment) as well as migration to foreign countries (“remittances from abroad”) were found to be three most important sources of deterioration in rural income distribution. The disequalising tendencies in respect of these three sources of rural income have magnified over the decade of the nineties.

While income from non-farm enterprises was equalising in the early nineties, it has become highly disequalising by the end of the decade – the concentration ratio rose from 0.22 to 0.48. At the same time, the share of non-farm enterprise income in total rural income increased from 15 to 20 per cent. As a result of the combined effect of these two tendencies, the contribution of this source of income to overall rural income inequality has increased from 12 to 27 per cent. Note that much hope is placed on these activities as a source of rapid and egalitarian growth. The result show that notwithstanding the expansion of non-farm microcredit and microenterprise loans (whose purported objective is to aid poverty reduction), the growth-equity trade-off in the context of rural non-farm growth has already set in and could become worrying in the course of the next decade.

⁹ The 1991/92 and 1995/96 figures are from Khan and Sen (2001) while the 2000 estimates are based on the same methodology. It may be noted that the BBS estimates differ from these estimates. As is known, the past BBS estimates of the income Gini index were based on the flawed “per household” income distribution rather than the preferred “per capita” income distribution. Besides, the BBS definition of “income” includes several kinds of non-income revenues, which need to be re-considered while computing the Gini index for relative income inequality. These items relate to capital receipts from the sale of assets, increase in financial assets, and receipts arising out of the repayment of loans made in the past. Excluding these items, Khan and Sen (2001) re-computed the Gini index for 1991/92 and 1995/96. The re-working gives lower figures for Gini in both rural and urban areas, though the underlying trend remains unaffected.

¹⁰ If a component of income whose contribution to inequality (as represented by the last column in Table 3) is higher than its per cent share of total income (as given in the second column in Table 3) then that particular source of income is termed as “dis-equalising”; a rise in its share of total income increases the Gini ratio. In the reverse case, it is termed as “equalizing”.

The second important disequalising source is salaried wage-employment. Although overall wage income component is still equalising in the rural context, there are clear signs of social polarisation within the labour market. While both casual agricultural and non-agricultural wage income activities have become more pro-poor, the salaried wage-employment has become a source of growing income inequality (the contribution of this source to overall rural income inequality has risen from 10 to 21 per cent).

Table II.3

Rural Income Inequality and its Sources

Sources of Income	Share of Total Income (%)		Gini/Concentration Ratio		Contribution of Income Component to Overall Inequality	
	1991/92	2000	1991/92	2000	1991/92	2000
Farm Income:	41.48	20.92	0.33	0.35	49.90	20.45
Crop	-	16.01	-	0.35	-	15.65
Livestock	-	1.47	-	0.24	-	0.99
Fishery	-	1.62	-	0.40	-	1.81
Forestry	-	1.83	-	0.37	-	1.89
Wage Income:	21.42	31.17	0.10	0.21	7.90	18.28
Casual Agri.	10.86	10.29	-0.11	-0.15	-4.38	-4.31
Casual Non-Agri.	4.23	7.33	0.14	0.07	2.17	1.43
Salaried (non-agri.)	6.32	13.55	0.45	0.55	10.42	20.82
Non-Farm Enterprise:	15.33	20.24	0.22	0.48	12.40	27.14
Property Income from Land:	0.89	3.41	0.55	0.56	1.80	5.33
Transfer and Remittance:	10.90	12.17	0.36	0.55	14.40	18.70
<i>Transfer</i>	-	1.31	-	0.06	-	0.22
♦ Informal	-	1.07	-	0.11	-	0.33
♦ Formal	-	0.24	-	-0.16	-	-0.11
<i>Remittance</i>	-	10.86	-	0.61	-	18.51
♦ Within	-	3.33	-	0.39	-	3.63
♦ Abroad	-	7.53	-	0.71	-	14.93
Rental Value of Housing:	7.74	5.29	0.35	0.33	9.80	4.88
Misc. Income:	2.29	6.79	0.37	0.27	3.60	5.12
Grand Total:	100.00	100.00	0.276	0.358	100.00	100.00

Source: The 1991/92 estimates are from Khan and Sen (2001). 2000 figures are estimated from the unit records of the Household Income and Expenditure Survey, 2000. Column totals do not always add exactly up to the amounts shown due to rounding error.

The third important source of rising rural income inequality is associated with remittance. Here again polarising tendencies are discernible. Remittance from internal migration appears to be only mildly dis-equalising. In contrast, remittance from abroad has emerged as a highly disequalising source of income, contribution of this source to overall rural income inequality being assessed at 19 per cent.

An important source of moderating rural income inequality has been agriculture over the period under consideration. Agricultural income (farm plus agricultural wage income) has a

concentration ratio of only 0.18 compared with 0.43 recorded for its non-agricultural counterpart (non-farm income plus non-agricultural wage income).¹¹ However, agriculture's potential for exerting equalising influence has been greatly compromised by its rapidly declining share in total rural income.

The disequalising forces in urban areas are broad similar to those in rural areas. In the beginning of the nineties non-farm self-enterprise income was a mildly equalising source; it has become sharply disequalising since then (Table II.4). Note that share of this source of income in 2000 has stayed at pretty much the same level as in 1991/92. This implies that the bulk of the disequalising influence was triggered by rise in concentration ratio for this income (the latter sharply increased from 0.31 to 0.50 over the entire decade).

Table II.4
Urban Income Inequality and its Sources

Sources of Income	Share of Total Income (%)		Gini/Concentration Ratio		Contribution of Income Component to Overall Inequality	
	1991/92	2000	1991/92	2000	1991/92	2000
Farm Income:	6.09	2.41	0.12	0.22	2.10	1.21
Crop	-	1.75	-	0.20	-	0.80
Livestock	-	0.23	-	0.05	-	0.03
Fishery	-	0.20	-	0.59	-	0.27
Forestry	-	0.23	-	0.19	-	0.10
Wage Income:	36.55	38.03	0.28	0.31	30.80	26.92
Casual Agri.	3.25	0.89	-0.03	-0.25	-0.30	-0.51
Casual Non-Agri.	10.01	8.03	0.09	-0.18	2.76	-3.30
Salaried (non-agri.)	23.29	29.11	0.40	0.46	28.40	30.57
Non-Farm Enterprise:	28.42	28.84	0.31	0.50	26.60	32.92
Property Income from Land:	3.76	1.59	0.64	0.51	7.40	1.85
Transfer and Remittance:	9.27	10.10	0.43	0.62	12.10	14.30
<i>Transfer</i>	-	4.27	-	0.78	-	7.60
Informal	-	4.25	-	0.78	-	7.57
Formal	-	0.02	-	-0.32	-	-1.46
Remittance	-	5.83	-	0.50	-	6.66
Within	-	1.93	-	0.30	-	1.32
Abroad	-	3.90	-	0.59	-	5.25
Rental Value of Housing:	9.19	12.77	0.43	0.58	12.20	16.91
Misc. Income:	6.72	6.26	0.42	0.42	8.70	6.00
Grand Total:	100.00	100.00	0.327	0.438	100.00	100.00

Source: The 1991/92 estimates are from Khan and Sen (2001). 2000 figures are estimated from the unit records of the Household Income and Expenditure Survey, 2000. Column totals do not always add exactly up to the amounts shown due to rounding error.

In contrast, salaried wage income, which was a highly disequalising source in early nineties, has become a mildly disequalising source over the same period. The contribution of this

¹¹ Additional estimates not shown in Table II.3.

source of income to overall urban inequality ranks second (31 per cent) right after the non-farm self-enterprise income (33 per cent). Rental income from housing represents the third important factor.¹² The contribution of this source of income to overall urban income inequality in 2000 was 17 per cent, up from 12 per cent recorded in 1991/92. Remittance from abroad represents a disequalising source in the urban context as well, though represents a much smaller share compared with the rural areas.

The preceding results show that examples of the so-called win-win policies that maximize growth and poverty reduction at the same time are not plentiful.¹³ This is because sectors that are found to be most growth enhancing also happen to exhibit pronounced tendencies towards increasing inequality. There appears existence of a situation of growth-inequality-poverty trade-off. The way out of this situation does not, however, lie in undermining the growth of the disequalising activities, but in ensuring that the poor people can effectively participate in them. The sources of rising inequality are linked with the uneven spread of economic and social opportunities, unequal distribution of assets especially in respect of human capital and financial capital, growing disparity between rural and urban areas as well as between developed and underdeveloped areas. Hence, these concerns need to be addressed for fostering inclusive and participatory growth. This requires prioritising the access of the poor, especially the extreme poor, to human and financial capital, and other forms of assets. Bridging household capability, on the one hand, and policy and market opportunity, on the other, would be a central part of the strategic thinking to operationalise the idea of ‘pro-poor economic growth’.

¹²The category of rental income from housing consists of two important sources, “imputed rent for owner-occupied housing”, and “house rental income received from tenants”. Additional calculations show that the concentration ratio is higher for the latter sources (0.68 vs. 0.49 for the urban area, and 0.55 vs. 0.30 for the rural area). It may be noted that the house rental income from the tenants constitutes about 50 per cent of total estimated rental income in the urban area while it is only 13 per cent in the rural area.

¹³ These findings are consistent with earlier results in the Bangladesh literature (Khan and Sen 2001; Hossain *et al.* 2002).

III. THE STRUCTURE AND SOURCES OF GROWTH

III.1 The Overall Growth Performance

Despite many obstacles – some man-made, some natural – the economy of Bangladesh experienced moderately accelerated growth in 1990s compared to previous decades. In the 1980s, per capita GDP had grown slowly at the rate of about 1.6 per cent per annum. In the first half of the 1990s, growth rate accelerated to 2.4 per cent and further to 3.6 per cent in the second half of the decade (Table III.1). This was not an insignificant acceleration, even though by no means spectacular by the standards of the rapidly growing countries of Asia.

Table III.1

Growth of Bangladesh Economy: 1980/81 – 1999/00:
(Annual average growth rates)

Sector	Five-yearly average				Decadal average	
	1980/81- 1984/85	1985/86- 1988/89	1990/91- 1994/95	1995/96- 1999/00	1980/81- 1999/00	1990/91- 1999/00
GDP	3.72	3.74	4.40	5.21	3.73	4.81
Population	2.13	2.19	1.98	1.60	2.16	1.79
Per capita GDP	1.59	1.55	2.41	3.61	1.57	3.01

Source: Computed from BBS (2000, annex table 8) and BBS (2001a, annex table 8)

The acceleration in the growth of per capita income owed itself both to a slowdown in population growth and a sustained jump in the rate of GDP growth (Table III.1). Population growth had remained more or less stable in the 1980s – at about 2.2 per cent per annum. But the onset of the 1990s ushered in a period of sustained slowdown. Fertility had begun to decline somewhat earlier, but sluggish improvement in mortality had kept population growth high. But in the first of the 1990s the rate of population growth dropped to 2 per cent and further to 1.6 per cent in the second half – indicating a remarkably early demographic transition for a country at as low a level of development as Bangladesh. At the same time, GDP growth also accelerated in tandem. From an average of around 3.7 per cent, which had prevailed in both halves of the 1980s, it rose to 4.4 per cent in the first half of the 1990s and accelerated further to 5.2 per cent in the second half of the decade.

This concurrence of a slowdown in population growth and acceleration in GDP growth in each half of the 1990s may not be purely coincidental, but any causal connections between the two have yet to be explored. For the time being, the least that can be said is that both productive and reproductive performance of the economy improved in the 1990s to generate a moderate acceleration in the growth of per capita income. In purely accounting terms, productive performance played the more dominant role, however, contributing about three-fourths of the observed acceleration. Thus, out of the 2 percentage point acceleration in per capita income growth that was experienced from the first half of the 80s to the second half of the 90s, as much as 1.5 percentage points came from GDP growth.

III.2 The Proximate Sources of Growth

This leads one to ask, what was the source of acceleration in GDP growth in the 1990s? We explore this question at two levels. First, at the proximate level, we look at the relative performance of economic sectors, to see which of them contributed most to growth acceleration. Next, at a somewhat deeper level, we try to identify forces that lie behind dynamics of the leading sectors.

As for sectoral contribution, it can be seen from Table III.2 that all three broad economic sectors – namely, agriculture, industry and services – contributed to the growth acceleration of the 1990s. The growth of agricultural GDP accelerated from 2.5 per cent in the 1980s to 3.2 per cent in the 1990s; industrial GDP accelerated from 5.8 to 7.0 per cent, and the service sector GDP from 3.7 to 4.5 per cent. The three sectors, however, performed differently in the two halves of the 1990s. Agriculture had lagged behind in the first half of the decade, but it picked up strongly in the second half; by contrast, industrial growth shot up sharply in the first half of the decade but subsided a little in the second half; services, on the other hand continued to accelerate throughout the decade.

Table III.2

Sectoral GDP Growth Rates: 1979/80 – 1999/00
(Annual average; in constant 1995/96 producer prices)

Sector	Five-yearly average				Decadal average	
	1980/81- 1984/85	1985/86- 1988/89	1990/91- 1994/95	1995/96- 1999/00	1980/81- 1999/00	1990/91- 1999/00
Agriculture	2.68	2.40	1.55	4.89	2.54	3.22
◆ Crop production	2.69	2.69	-0.43	3.86	2.69	1.72
◆ Fisheries	3.06	1.64	7.86	8.56	2.35	8.21
◆ Others	2.40	2.21	2.53	3.30	2.31	2.92
Industry	5.70	5.80	7.47	6.44	5.75	6.96
◆ Manufacturing	4.69	5.27	8.20	5.59	4.98	6.90
◆ Large & medium	4.44	5.43	8.41	5.49	4.94	6.95
◆ Small scale	5.41	4.89	7.69	5.87	5.15	6.78
◆ Construction	6.44	5.59	6.27	8.80	6.02	7.54
◆ Others	11.50	10.68	6.43	4.90	11.09	5.67
Services	3.83	3.58	4.14	4.81	3.71	4.48
Total GDP	3.72	3.74	4.15	5.23	3.73	4.69

Source: Computed from BBS (2000, annex table 1) and BBS (2001a, annex table 1)

At a further level of disaggregation, the two fastest growing sub-sectors are found to be fisheries (which experienced a very sharp growth acceleration from 2.4 per cent in the 1980s to 8.2 per cent in the 1990s) and manufacturing (which experienced a moderate acceleration from 5.8 per cent to 7.0 per cent). It is no coincidence that fisheries – especially, frozen shrimp – and manufactured goods – especially, readymade garments and knitwear– also happened to be the fastest growing export items in the 1990s (Table III.3). The export of readymade garments and knitwear grew especially fast, their share in total export earnings

increasing from some 40 per cent at the close of the 1980s to nearly 75 per cent at the close of the 1990s.

It would thus appear that the outward-looking macroeconomic policy pursued by Bangladesh in the recent past did succeed in stimulating some parts of the economy – so much so that they turned out to be the most rapidly growing activities in the 1990s. But it does not necessarily follow that the superior growth performance of Bangladesh economy in the last decade can be explained primarily by these activities. For identifying, major sources of growth acceleration, it is not enough to look at the sectoral rates of growth. The weights of the sectors also matter and the fact is that the combined weight of the most rapidly growing activities in the overall economy is still rather small.

Table III.3
Fastest Growing Export Items in the 1990s
(Annual average exports in million US dollars)

Export item	1989/90 – 1991/92	1998/99 – 2000/01
Readymade garments & knitwear	891	4411
Frozen foods (mainly frozen shrimp & fish)	137	327
All other exports	717	750
Total exports	1745	5488

Source: World Bank (1999a) and GOB (2002)

One plausible way of identifying sources of growth acceleration is to identify sectors that made largest absolute contributions to incremental growth in national GDP in the 1990s. For this purpose, first absolute growth in sectoral GDPs over the 1980s needs to be estimated and then the exercise for the 1990s be repeated. The difference between the two – i.e. the absolute size of the incremental growth in sectoral GDPs over the two decades – would indicate which sectors contributed most to the superior growth performance of the 1990s.

In order to carry out this exercise, it is first necessary to locate turning point as precisely as possible. Since random fluctuations in annual growth rate can make this task difficult, three-year moving average of growth rates in the last two decades has been taken. The results, presented in Table III.4, clearly reveal that triennium around 1989/90 (i.e. the three-year period from 1988/89 to 1990/91) was the watershed after which the Bangladesh economy embarked on a slightly higher growth path in a sustained manner. Before this triennium the moving average hovered mainly between 3 and 4 per cent; afterwards, it never fell below 4 per cent and after the mid-1990s never below 5 per cent.

Table III.4**Annual GDP Growth Rates: 1980/81 – 2000/01**

Year	Annual GDP growth rate (%)	Three-year moving average of GDP growth rate (%)
1980/81	3.80	---
1981/82	2.38	3.40
1982/83	4.02	3.86
1983/84	5.18	4.14
1984/85	3.22	4.22
1985/86	4.25	3.73
1986/87	3.73	3.38
1987/88	2.16	2.83
1988/89	2.61	3.57
1989/90	5.94	3.96
1990/91	3.34	4.77
1991/92	5.04	4.32
1992/93	4.57	4.56
1993/94	4.08	4.53
1994/95	4.93	4.54
1995/96	4.62	4.98
1996/97	5.39	5.08
1997/98	5.23	5.17
1998/99	4.88	5.35
1999/00	5.94	5.33
2000/01	5.16	---

Source: Computed from BBS (2000, annex table 1) BBS (2001a, annex table 1)

Taking 1988/89-1990/91 as the dividing line, absolute growth in sectoral GDPs in nine-year period between the triennia 1979/80-1981/82 and 1988/89-1990/91 was compared with those in subsequent nine-year period up to triennium 1997/98-1999/00. For the purposes of the present analysis, these two nine-year periods are designated as the 1980s and the 1990s respectively.¹⁴ The first column of Table III.5 shows the extent to which average annual GDP of various sectors increased in real terms between the terminal points of the 1980s. The second column shows corresponding increase in the 1990s. The third column gives the difference between the two – it shows the extent to which different sectors contributed to the incremental growth of GDP from one decade to the next. The final column expresses these contributions as shares of incremental growth in national GDP over the 1990s.

¹⁴ It was not possible to take a standard 10-year decade as consistent national income estimates are available only from 1979/80 onwards.

Table III.5

Sectoral Contribution to Growth Acceleration between 1980s and 1990s
(In 1995/96 prices)

Sector	GDP growth over the 1980s (billion taka)	GDP growth over the 1990s (billion taka)	Incremental GDP growth from 80s to 90s (billion taka)	Sector share in incremental GDP growth (%)
Agriculture	65.36	113.67	48.31	16.86
Crop production	40.51	38.42	-1.73	-0.60
Fisheries	11.36	54.57	43.21	15.08
Others	13.49	20.68	7.19	2.51
Industry	102.36	222.33	119.97	41.86
Manufacturing	56.22	135.73	79.51	27.75
Large & medium	39.66	97.72	58.12	20.28
Small scale	16.58	37.99	21.41	7.47
Construction	29.26	68.68	39.42	13.76
Others	16.88	17.92	1.04	0.36
Services	174.05	292.33	118.28	41.28
Total GDP	341.77	628.33	286.56	100.00

Notes:

- (1) 1980s refer to the nine-year period from the triennium 1979/80-1981/82 to the triennium 1988/89-1990/91; 1990s refer to the nine-year period from the triennium 1988/89-1990/91 to the triennium 1997/98-1999/00.
- (2) GDP growth refers to the difference in the average annual GDP of the two terminal triennia of a period.
- (3) Acceleration in GDP growth refers to the difference in the GDP growth of the two periods – 1980s and 1990s.

Source: Computed from BBS (2000, annex table 1) and BBS (2001a, annex table 1).

As can be seen from Table III.5, industry and services contributed almost equally to the incremental growth in the 1990s, each with a share of about 41 per cent, with agriculture making a lowly contribution of just 17 per cent. Within the broad group of industry, the manufacturing sub-sector contributed 28 per cent, out of which some 20 per cent came from large and medium industries, and the rest from small-scale industries. In agriculture, fisheries made an overwhelmingly large contribution, accounting for 15 out of the 17 per cent contribution that came from all of agriculture.

From the point of view of macroeconomic policy, a pertinent issue concerns the relative roles of tradable and non-tradable sectors in the process of growth acceleration. In the context of Bangladesh, services are almost entirely non-tradable. Within the broad group of industry, construction is non-tradable, and even the products of small-scale industry ought to be counted as non-tradable because the generally poor quality of these products make them very imperfect substitutes of goods traded in the world market. Only large and medium scale industry can be regarded as genuinely tradable sectors. In agriculture, rice, the major crop, is practically non-tradable, as its price tends to vary between the import parity price and the export parity price. A part of fisheries is certainly tradable, however, and, as mentioned before, has played a leading role in the process of export expansion in the recent years.

On the basis of this classification, only large and medium scale industries and fisheries are to be counted as the major tradable sectors in Table III.5. Their combined contribution in the

incremental growth of the 1990s is found to be 35 per cent. However, since fisheries contain a significant non-tradable component, catering only to the domestic market, it is safe to assert that total contribution of the tradable sector would be somewhere between a quarter and a third. This implies that at least two-thirds to three-quarters of the incremental growth in the 1990s originated from non-tradable sectors – mainly, services, construction and small-scale industry.

The increasing dominance of non-tradables in general and services in particular can also be seen from the changing composition of labour force (Table III.6).

Table III.6
Sectoral Share of Labour Force: 1990/91 and 1999/00
(in million)

Sector	Absolute numbers		Percentage share	
	1990/91	1999/2000	1990/91	1999/2000
Agriculture	180.59	215.46	51.82	50.32
Industry	64.95	57.01	18.60	13.31
Manufacturing	59.25	42.19	16.97	9.85
Construction	5.25	11.39	1.50	2.66
Services	103.61	155.71	29.67	36.37
Total	349.15	428.18	100.00	100.00

Source: Bangladesh Labour Force Surveys.

During the 1990s, agriculture lost a bit of its share of labour force, and manufacturing lost considerably - from 17 per cent in 1990/91 it came down to just 10 per cent in 1999/00. By contrast, services increased its share from 30 per cent to 37 per cent during the same period and construction raised its share from 1.5 to 2.7 per cent. There was thus a clear shift of labour force towards the non-tradable sectors, which is consistent with the pattern of growth in production discussed above.

The implications of these findings deserve careful consideration in the context of the ongoing debate regarding the role of macroeconomic policy in promoting growth and reducing poverty. One immediate lesson is clear. The fact that the tradable sectors enjoyed the fastest acceleration of growth in the last decade does not by itself imply that the superior growth performance of the overall economy owed itself primarily to the tradables and to the macroeconomic policy reforms that tilted the structure of incentives towards them. In purely accounting terms, the non-tradables in fact played a more dominant role.

However, without further analysis these findings do not rule out a dominant causal role of macroeconomic reforms. For it is entirely conceivable that the stimulus to growth in the non-tradable sector came from the superior performance of the tradable sectors. It is, therefore, necessary to dig a little deeper to unearth the underlying forces that stimulated the accelerated growth of non-tradables.

III.3 The Underlying Sources of Growth

In theory it is possible that the non-tradables enjoyed a kind of endogenous growth arising from autonomous productivity improvement within the sector. There is, however, no plausible basis for believing that this actually happened in the service sectors, construction industry or in small-scale manufacturing in Bangladesh. It is much more likely that the stimulus came from outside – in the form of a demand boost. One reason why a demand boost – if it were to exist – could be expected to work is that there is considerable underemployment of labour in the non-tradable sector. The overall rate of underemployment (defined as working less than 35 hours during the reference week) has been estimated to be as high as 43 per cent in 1990/91. Although sectoral distribution of underemployment is not directly available, it is clear that most of it would be found in the informal sector – where the non-tradables mostly belong – because that is where the practice of work-sharing is more likely to prevail. Given the existence of such a huge pool of underemployed labour, it is a plausible hypothesis that some external demand stimulus spurred the accelerated growth of non-tradables in the 1990s, bringing down the overall rate of underemployment from 43 per cent at the beginning of the decade to 35 per cent at the close.¹⁵

This leads to the question: where did the stimulus of demand come from? The three possible sources are examined below:

- ◆ The phenomenal growth of the garments industry,
- ◆ Increasing volume of remittance sent by migrant Bangladeshi workers, and
- ◆ Agriculture – the classic source of demand for an economy at a low level of development.

To all observers of the Bangladesh economy, the first two sources would have an immediate claim to plausibility. From its modest beginnings in the early 1980s, the readymade garments (RMG) industry has registered phenomenal growth, to become both the leading industry and the leading export item of Bangladesh. By the mid-1990s, it was contributing somewhere between 20 and 25 per cent of total value-added and employing between 40 and 50 per cent of the workforce engaged in large and medium scale manufacturing. In 1983/84, its share in total exports was barely 4 per cent; by the end of the last decade, it had risen to 75 per cent.¹⁶ The growth of RMG was especially rapid in the last decade. By 1990/91, there were fewer than 1000 units, but by the end of the decade nearly 3000 units were in operation. In 1988/89, its value-added was less than Tk 10 billion, but by 1997/98 it had risen to Tk 35 billion.¹⁷ These figures suggest that the additional income generated by the exceptionally rapid growth of RMG in the 1990s could have offered a significant demand boost to services and other non-tradables as the workers engaged in this sector spent their hugely increased purchasing power. Since garments workers happen to be some of the poorest among manufacturing workers,¹⁸ their spending pattern must have been skewed more towards the inferior quality goods and services produced in the informal non-tradable sector than those produced in the

¹⁵ The estimates of underemployment are from Salmon (2002), Table 2.1, p.31. These are based on what is known as the ‘extended definition’ of labour force, in which unpaid family labour engaged in household-based productive activities are counted among the labour force. Furthermore, 10 years is taken as the cut-off point for the purpose of defining working age population. Alternative estimates, based on 15 years as the cut-off point, are available for 1999/00 but not for 1990/91.

¹⁶ For a detailed account of the growth and characteristics of RMG in Bangladesh, see Khundker (2002). See also Bakht (2001) and Dowlah (1999).

¹⁷ Both years’ figures are in constant 1995/96 prices. The current price figures are from the Census of Manufacturing Industries of the respective years. These were converted into constant prices by using the implicit sectoral GDP deflators for the large and medium scale manufacturing sector.

¹⁸ According to the Census of Manufacturing Industries data for 1997/98, the cost per employee in the garments sector was nearly half of that in the rest of the manufacturing sector.

formal tradable sector or those imported from abroad. This must have provided a significant demand boost to the production of non-tradables.

Remittance from emigrant Bangladeshi workers is yet another area of rapid growth in Bangladesh. Although international labour migration has a long history in Bangladesh, remittance began to assume some quantitative significance since the mid-1970s when the oil wealth of the Middle East attracted thousands of workers from poor countries. In the two decades since 1980, the volume of remittance sent by Bangladeshi workers has grown at the rate of 8.5 per cent per annum in real terms. By the end of the 1990s, the annual receipts had amounted to roughly 30 per cent of export earnings and over 4 per cent of GDP. Another revealing statistic is that the purchasing power that is currently generated by workers' remittance is far above the value-added created by RMG despite the phenomenal growth of this sector in the last decade. Thus in 1997/98, the latest year for which survey data on industries is available, RMG created value-added of Tk 35 billion, while remittance brought in Tk 64 billion worth of purchasing power.¹⁹

As in the case of RMG, remittances experienced a particularly accelerated growth in the 1990s. In constant 1995/96 prices, the volume of annual remittance increased by Tk 17 billion in the decade of the 1980s, but in the next decade it rose by nearly Tk 50 billion. As a result of this accelerated growth, the size of remittance as a proportion of GDP went up from 2.5 per cent in 1990/91 to 4.1 per cent in 1999/00 despite the fairly rapid growth that GDP itself experienced during this period. It is, therefore, reasonable to assume that the rapidly rising volume of remittance must have acted as a source of demand stimulus for the non-tradables in the 1990s.

The third and final source considered is agriculture. Much has been written about the importance of agriculture-led growth for economies at low levels of development. The sheer weight of this sector in the overall economy implies that even modest growth in agricultural income can spur rapid growth in other sectors – mainly through consumption linkages. Agriculture can, therefore, be expected to play the role of the lead sector at the early stages of development. There is, however, a presumption in much of recent literature on the Bangladesh economy that agriculture may have ceased to play this role since the beginning of the 1990s. This presumption is based on the experience of the early 1990s when the overall economy seemed to have embarked on a higher growth path despite a slowdown in the rate of agricultural growth. The evidence can be seen from Table III.2, which shows that agricultural GDP grew at just 1.55 per cent per annum in the first half of the 1990s compared to 2.40 in the second half of the 1980s. Indeed, the observed slowdown in agricultural growth spawned a lively debate at that time on whether Bangladesh agriculture had entered a phase of secular stagnation, with the Green Revolution running out of steam and new technological breakthroughs yet to occur²⁰. The subsequent rebound in growth – in the second half of the 1990s – has laid the thesis of secular stagnation to rest, at least for the time being. However, the presumption still prevails that the growth spurt enjoyed by the Bangladesh economy in the early 1990s owed little to agriculture.

¹⁹Both figures are in constant 1995/96 prices. Strictly speaking, the comparison should be made with the overall contribution of the RMG sector including the value-added created in the earlier stages of production. But in view of the fact that the industry is highly import-intensive with very weak domestic backward linkages, the overall comparative picture would still stand the test of a more refined analysis.

²⁰For arguments and evidence pertaining to this debate, see, in particular, Adnan (1999), Palmer-Jones (1999) and Shahabuddin (1999a).

We shall argue that this view is mistaken, and the mistake lies in ignoring the long-term pattern of agricultural growth in Bangladesh. The analysis of production data shows that ever since the mid-1970s agricultural output has been characterised not by continuous growth around a trend line but by a number of discrete jumps at irregular intervals. In other words, output would grow very slowly, if at all, for a number of years and then jump to a higher level, but after having reached the higher level it would revert back to slow growth until the next jump, and the process would repeat itself. The growth of agricultural output is thus characterised by a number of distinct plateaux, each plateau marking a significant improvement over the preceding one, but with very little increase in output within any given plateau.

One implication of this pattern of growth is that if one compares output between two points in time both of which belong to the same plateau, then one would probably find stagnation, but this would hide the important fact that output is growing in discrete jumps. This is precisely the case with the observed stagnation in the early 1990s. Agricultural output, especially the production of rice, had experienced a quantum jump at the end of the 1980s, heralding a new plateau that persisted for most of the 1990s. Naturally, comparison - between any two years of the early and mid - 1990s would indicate stagnation, but it would only mask the fact that new plateau was significantly higher than the one that existed for most the 1980s²¹. Thus, after hovering around a total of 14 to 15 million metric tons almost throughout the 1980s, the production of rice jumped, reaching close to 18 million in 1989/90 and stayed there for most of the 1990s until it jumped again towards the end of the decade. This represents a jump of nearly 20 per cent in the production of the biggest crop of Bangladesh agriculture.

The credit for bringing about this quantum jump in crop production goes mainly to liberalisation of markets for agricultural inputs, especially elimination of non-tariff barriers to importation of cheap irrigation equipment. Because of import liberalisation, which took effect in 1988, the price of shallow tube-well (STW) in particular came down drastically. By 1989, the price of a middle-sized STW had come down by 40 per cent compared to even the subsidised price at which it was available before from the government agency. This fall in price, combined with relaxation in sitting restrictions, resulted in an enormous expansion in the extent of irrigated area – from an average of 2.3 million acres in the three year period 1984/85-1986/87, it jumped to an average of 3.5 million in the next three years. In turn, the expansion of irrigated area brought about a correspondingly sharp increase in use of fertiliser and high-yielding seeds. For instance, the use of fertiliser went up from an average of 1.2 metric ton during 1984/85-1986/87 to an average of 1.7 million metric ton in the next three years.²² All this increase in the use of inputs contributed to the discrete jump in rice production in the late 1980s.²³

The co-ordinated expansion in the use of agricultural inputs was sustained throughout the 1990s, so that the elevated level of rice production that was reached in the late 1990s was maintained over the subsequent years. As a result, the rice sector must have generated a substantial as well as sustained demand boost to non-crop sectors in each year of the 1990s over and above anything they had enjoyed in preceding decade. This would have surely contributed to superior growth performance of non-tradables in the 1990s.

²¹ For an earlier formulation of this argument, see Osmani (1994). See also Palmer-Jones (1999).

²² These figures on the use of irrigation and fertiliser are obtained from Abdullah *et al.* (1995), Appendix Tables 5.4A and 5.3 A respectively

²³ The policy reforms in agriculture and their impact are discussed extensively by Hossain (1995, 1996). For a detailed analysis of the impact of input market liberalisation and for econometric evidence that such liberalisation was the major factor behind the acceleration of rice production in the late 1980s, see Ahmed (2001).

Thus, three distinct sources have been identified— namely, the readymade garments industry, migrant workers’ remittance, and a quantum jump in crop production each of which is likely to have provided a demand boost to non-tradable. The next task is to assess relative quantitative significance of the three sources. Note that our objective is to explain additional or incremental growth of non-tradables in 1990s over and above the growth that occurred in the 1980s, which has been shown in column 3 of Table III.5. Accordingly, the extent of demand boost should be measured as the increment or excess of demand that came from the three sources in the 1990s as compared with the 1980s. This has been done in Table III.7, where the three-year average for triennium 1986/87-1988/89 has been taken as benchmark over which ‘excess’ is to be measured. The difference between this benchmark and any subsequent year gives excess for that particular year, and the average of all these annual figures gives overall annual excess of demand stimulus for whole of the 1990s.

The result, which would perhaps surprise many, is that crop production turns out to have been by far the most important source of enhanced demand stimulus among the three that we have considered. In fact, even combined stimulus from other two sources (viz. RMG and remittance) was less than stimulus that came from crop production alone – Tk 25 billion as against Tk 30 billion in constant 1995/96 prices. As the decade progressed, however, RMG and remittance began to assume greater importance. But even towards the end of the decade crop production remained the single most important source of enhanced demand.

The preceding analysis can be summarised as follows. The economy of Bangladesh experienced a distinct, albeit modest, acceleration in growth in the 1990s in comparison with preceding decade. Although tradable sectors – mainly, large and medium scale industries and fisheries – enjoyed fastest acceleration in growth, their overall weight in economy was not large enough to account for major part of overall growth acceleration. It is in fact the non-tradable – specifically, combination of services, construction and small-scale industry – that appear to have been most important proximate source of superior growth performance in the 1990s. Further analysis suggests that underlying force behind accelerated growth of non-tradable was most likely to have been some kind of demand stimulus from outside the sector rather than internal productivity improvement. The demand stimulus in turn came primarily from a quantum jump in crop production that occurred in late 1980s and to a lesser extent from rapid growth that occurred in the flow of income generated by RMG and workers’ remittance from abroad.

Table III.7

Sources of Demand Stimulus to Growth Acceleration in the 1990s

(Figures are in billion taka at constant 1995/96 prices)

Year	Crop Production		Readymade Garments		Foreign Remittance	
	Value-added	Excess over 86/87-88/89	Value-added	Excess over 86/87-88/89	Value	Excess over 86/87-88/89
1986/87-1988/89	215.49	---	9.37	---	36.10	---
1989/90	241.18	25.69	---	---	33.76	-2.34
1990/91	243.21	27.72	---	---	32.68	-3.42
1991/92	245.91	30.42	8.46	-0.91	37.66	1.57
1992/93	248.29	32.80	13.07	3.69	43.04	6.94
1993/94	244.17	28.68	20.39	11.01	48.74	12.64
1994/95	235.82	20.33	---	---	50.20	14.10
1995/96	239.93	24.44	43.43	34.06	49.70	13.60
1996/97	255.37	39.88	---	---	61.10	25.00
1997/98	258.06	42.57	35.26	25.89	63.87	27.78
Average annual stimulus in the 1990s	---	30.28	---	14.75	---	10.65

Notes and Sources:

(1) Constant price value-added for crop production were obtained from BBS (2000, annex table 1, p.23) and BBS (2001a, annex table 1, p.81).

(2) For RMGs, information on value-added is available only for the years in which the Census of Manufacturing Industries have been conducted. The current price value-added for the 1990s was taken from Statistical Yearbook of Bangladesh 2000, Table 5.33, p.227. For the late 1980s, information is available only for 1988-89, which has been taken as representative of the late 1980s. Current price value-added for this year was obtained by applying the weight for RMGs in total value-added of large and medium manufacturing in 1988-89, as reported by Bakht (2000, annex table A.7, p.79), on the sectoral value-added of large and medium manufacturing in current prices for the same year, as reported in BBS (2001a, annex table 4, p.84). Constant price value-added for all the years were obtained by using implicit sectoral GDP deflators for large and medium manufacturing, as reported in BBS (2000, annex table 7, p.29) and BBS (2001a, annex table 7, p.87).

(3) Current price values of foreign remittance were obtained from GOB (2002, annex table 44, p.187) and were converted into constant prices by using implicit GDP deflators as reported in BBS (2000, annex table 7, p.29) and BBS (2001a, annex table 7, p.87).

Macroeconomic policy reforms played a role in creating demand stimulus by promoting crop production (through liberalisation of agricultural input markets) and by encouraging growth of RMGs industry (through trade sector reforms). The role of macroeconomic policies has been examined in greater detail in the subsequent sections. But prior to that relationship between growth and poverty in the context of Bangladesh has been delineated.

IV. THE GROWTH-POVERTY NEXUS AND ITS IMPLICATIONS FOR A PRO-POOR MACROECONOMIC POLICY REGIME

IV.1 The Growth-Poverty Nexus

Faster growth in the 1990s was associated with faster rate of poverty reduction compared to the 1980s. There are reasons to believe that this was more than a mere association. Since overall income inequality increased during this period – in both rural and urban areas – faster growth must have played a causal role in reducing poverty. In order to identify the precise nature of this causal relationship, it is necessary to look more closely at growth process and nature of growth-poverty nexus it engendered. This will help us gain a better understanding of poverty dynamics in Bangladesh, which in turn will help to formulate a pro-poor macroeconomic policy regime.

In Bangladesh the non-tradable activities, especially those outside agriculture, played leading role in bringing about accelerated growth in 1990s. Therefore, the search for the growth-poverty nexus calls for a deeper analysis of the nature of growth in these activities. The sources of their growth have already examined. It remains to explore precisely how their growth affected the poor. For this purpose, a close look at the rural non-farm (RNF) sector has been taken in recognition of the fact that most of the poor live in rural areas.

A sizeable proportion of rural labour force has shifted from farming to non-farm activities in the last two decades. In 1983/84, some 34 per cent of the rural labour force was engaged in non-farm activities as their principal occupation; by the year 2000 this figure stood at 39 per cent. This increase in the relative size of the non-farm sector is an outcome of contrasting trends between male and female participation. The proportion of males engaged in this sector has increased almost continuously throughout last two decades, while proportion of females has declined sharply (Table IV.1).

Table IV.1
Trends in the Share of Non-Farm Sector in Rural Population
(percentage)

Sex	1983/84	1984/85	1990/91	1995/96	1999/00
Both sexes	34.3	34.4	38.6	37.8	38.7
Male	28.5	29.4	35.1	35.0	38.6
Female	89.5	88.8	61.3	51.0	39.0

Notes and Sources: Labour Force Survey, various years. Employment estimates are based on the 'usual definition'.

Apart from this gender contrast, there are also some interesting contrasts between decades of the 80s and the 90s in the way this sector has developed. First, the pace of the shift from farm to non-farm sector appears to have slowed down somewhat in the 1990s – this was especially true in the first half of the decade. But the more important contrast, for the present purpose, lies in structure of the RNF sector. Although there are no systematic surveys of this sector that would enable us to get a clear view of how its structure might have changed over time, some reasonable inferences has been made by piecing together a number of different kinds of

evidence. The broad picture that emerges is that in the 1980s the shift to the RNF sector took place primarily at the lower end of the productivity scale – in the form of low-earning self-employment. By contrast, in the 1990s, the RNF sector witnessed relative expansion of larger scale enterprises, which employed wage labour, and which were more productive than kind of low-end self-employed activities that had expanded more in the previous decade. These contrasts have important implications for evolving nature of poverty dynamics in Bangladesh. But first the evidence has been looked at.²⁴

For the 1980s, the following pieces of evidence are worth noting. First, according to the 1990/91 LFS data, self-employed workers, including unpaid family helpers accounted for about two-thirds of rural male non-farm workers. This proportion remained unchanged or may even have increased, since early 1980s²⁵. In a dynamic setting, one would expect this proportion to fall over time as average scale of activity becomes larger and as the importance of semi-urban-type employment increases within broadly defined ‘rural’ areas. The fact that the reverse has happened suggests that the shift of labour force from agriculture to the RNF sector took place disproportionately at the lower end of the productivity scale where self-employment predominates.

Second, proportion of landless households among all rural households increased in the 1980s – from 34 to 41 per cent according to Population Censuses. However, there is no evidence of an increase in proportion of landless among agricultural households. This suggests that the increment in landless households were absorbed almost entirely in the RNF sector. In fact, size of this increment is large enough to account for the entire shift of labour force that occurred during this period. It would thus appear that the shift of labour out of agriculture can be entirely accounted for by increasing landlessness, and not by increasing number of land-owning households diversifying their sources of income towards non-farm activities. It can be concluded, therefore, that this shift has taken place at the lower end of the income scale, since land ownership and income are strongly correlated.

Third, for the period of the 1980s, the Household Expenditure Surveys (HES) data do not show much increase in per capita rural income, but the annual growth in agricultural real incomes according to the national income estimates appear to have slightly exceeded that of rural population. This implies that the growth rate of income in the RNF sector could not have been higher than that of rural population. This would give a scenario of declining overall labour productivity in the RNF sector, given the shift of rural labour force from agriculture to the RNF sector. This pattern would be consistent with a proliferation of low-productivity activities within the RNF sector and possibly some overcrowding in these activities.²⁶

For the 1990s, the following pieces of evidence can be put together²⁷. First, after remaining more or less static in the 1980s, the proportion of self-employed workers in the RNF sector declined in the 1990s - from 66 per cent in 1990/91 to 59 per cent in 1995/96. This implies a rise in the proportion of wage-labour based enterprises, which are likely to be somewhat

²⁴ The relevant evidence is discussed more fully in Mahmud (1996, 2001b).

²⁵ According to the LFS data, this proportion is estimated to be about 55 per cent for 1983/84 compared to 66 per cent for 1990/91. However, the estimate for 1984/85 is almost similar to that for 1990/91.

²⁶ There is also some direct evidence of overcrowding and declining productivity in some specific areas such as handloom and other cottage industries (Mahmud 2001b).

²⁷ For fuller discussion of these and related evidence on the growth and structure of the non-farm sector in Bangladesh, see Mahmud (1996, 2001b).

larger in scale and more productive than the enterprises involving mainly self-employed workers that predominated in the 1980s.

Second, the distribution of non-farm income became noticeably more unequally distributed in the 1990s. As can be seen from Table II.3, among all the components of rural income, non-farm enterprise income experienced the sharpest increase in inequality – the concentration ratio increased from a lowly 0.22 to a surprisingly high 0.48. The concentration ratio of income from salaried employment in this sector also increased – from 0.45 to 0.55. These findings suggest that during the 1990s the growth of the RNF sector tilted to some extent away from low-productivity self-employment towards relatively larger-scale enterprises that generated larger profits for better-off entrepreneurs and allowed greater differentiation between skilled and unskilled workers.

Third, HIESs show there was a sharp increase in the share of non-farm income out of total rural household income in the 1990s – from 26 per cent in 1991/92 to 41 per cent in 1999/00. But this was also a period when, according to the LFSs, there was a slowdown in the shift of agricultural labour to the RNF sector. This would mean that not only did the RNF sector grow more rapidly in terms of value-added compared to the 1980s there was also an increase in average labour productivity in the RNF sector. Since average labour productivity is positively correlated with the scale of the enterprise, this finding indicates a tilt towards relatively larger-scale enterprises in the 1990s.

Based on these sets of evidence, the transformation that has occurred between the two decades can be summarised as follows. A rapid shift of labour force into the RNF sector in which the predominant move was into self-employment at the lower end of the productivity scale has given way to a less rapid shift but one that has been characterised by faster growth of relatively larger-scale enterprises that are more productive and employ more wage labour. The poor rural workers have thus found an increasing opportunity to secure wage employment in the RNF sector instead of overcrowding into petty small-employed activities.

This transformation in the dynamics of rural labour force has important implications for the dynamics of poverty in rural Bangladesh. These implications arise from the difference in labour rewards that exist between farm and non-farm sectors on the one hand and between self-employment and wage employment in the RNF sector on the other. This can be seen from Table IV.2, which shows the returns to labour under different modes of employment in the two sectors, and for different income groups.

Table IV.2

**Returns to Labour by Mode and Sector of Employment
And by Poverty Status in Rural Areas: 1999/00
(Taka per day per worker)**

Poverty Status	Farm		Non-Farm		
	Self-employment	Casual wage labour	Casual wage labour	Self-employment	Salaried wage labour
Extreme Poor	16.43	30.15	40.53	38.47	56.10
Moderate Poor	25.76	35.93	49.93	65.60	71.38
Moderate Non-Poor	36.07	35.70	57.16	85.75	85.85
Rich Non-Poor	47.73	37.39	72.42	239.58	125.30
<i>All Poor</i>	22.75	33.33	45.70	57.22	63.75
<i>All Non-Poor</i>	40.51	36.71	61.10	157.68	107.28
<i>All Households</i>	33.15	33.85	51.98	116.08	96.29

Source: Estimated from the unit records of *Household Income and Expenditure Survey, 2000*.

In this table, rural population has been classified into four broad groups: the extreme poor (bottom two deciles), the moderate poor (next three deciles), the moderate non-poor (next three deciles), and the rich non-poor (top two deciles). The first interesting point to note is that for each income group any mode of employment in the non-farm sector is on the average far more rewarding than any mode of employment in the farm sector. It is this difference in the relative returns to labour that lies behind the shift of labour force towards the non-farm sector. The second interesting point concerns the gradation of returns within the non-farm sector. For the poor, and especially for the poorest two deciles (the extreme poor), salaried jobs are far superior to self-employment in this sector.²⁸ These findings suggest that when the poor shift from farm to non-farm activities, they will on the average gain, but the gain will be considerably higher if they are able to enter into salaried employment as compared with self-employed activities.

The nature of the growth-poverty nexus that operated in the 1990s can now be summarised as follows. Boosted by enhanced demand – emanating initially from the crop sector and increasingly also from the RMGs and workers’ remittances – the non-tradable non-farm sector experienced accelerated growth in the 1990s. Faster growth enabled the non-farm enterprises to increase their scale of operation, thus tilting the structure of RNF sector more towards the relatively larger enterprises. This structural change in turn brought about a change in the nature of labour absorption in this sector, as salaried wage employment became more plentiful with the emergence of larger enterprises. Whereas in the 1980s most of the surplus labour that got absorbed in the non-farm sector found their way into low-productivity self-employment, in the 1990s the absorption occurred more into salaried employment in the relatively larger and more productive enterprises. Since salaried employment in larger scale enterprises was far more rewarding for the poor than the shift into self-employment that

²⁸ Even for the moderate non-poor salaried jobs are at least as good as self-employment. It is only for the very rich that self-employment in the non-farm sector is decidedly more rewarding than salaried jobs.

occurred in the 1980s, the structural change engendered by the growth process of the 1990s was especially conducive to poverty reduction.

IV.2 Implications for Macroeconomic Policy

It follows from the preceding analysis that if macroeconomic policy is to hasten the pace of poverty reduction in Bangladesh in the near future, it ought to strengthen the process whereby the relatively larger scale non-farm enterprises – mostly in the non-tradable sector – can prosper rapidly so that the surplus labour of the farm sector can be absorbed quickly into salaried jobs in such enterprises.

For this to work, macroeconomic policy will have to work on both demand and supply sides. On the demand side, it will have to help create the conditions in which the demand will continue to boost the production of non-tradables. On the supply side, it will have to help remove the impediments that at present prevent the poor from taking full advantage of any growth in this sector.

Information on the structure of employment indicates that such impediments do in fact exist. For instance, in spite of the fact that salaried jobs in the non-farm sector offer the highest returns to labour to the poor, the proportion of their workforce employed in this mode is found to be the lowest. A comparison of employment structure between the poor and the moderate non-poor shows that the poor in fact lag behind in self-employment as well, in both farm and non-farm sectors, but the biggest difference lies with respect to salaried jobs in the non-farm sector, where their involvement is only half of that of the moderate non-poor (Table IV.3). Thus, only about 6-7 per cent of the poor households' workforce has salaried jobs in the non-farm sector, as compared with twelve per cent among the moderate non-poor. This suggests that access to salaried jobs in the non-farm sector is a major distinguishing feature between these two groups. Evidently, the impediments that lie in the access to such jobs play a crucial role in preventing the poor from escaping the poverty trap.

This is not to suggest that access to salaried jobs is the only route out of poverty. As the data in Table IV.2 reveal, self-employment in non-farm activities can be quite enriching too, but not if these are the kinds of employment that are available for the extreme poor. For them, self-employment in the non-farm sector does not bring any higher reward compared to casual labour in the same sector. Self-employment is more rewarding only if they can engage in the kind of work in which the moderate non-poor are engaged. Otherwise, salaried jobs are a better option – for both the extreme poor and the moderate poor. It is only after one crosses the poverty threshold that self-employment in non-farm activities begins to catch up with salaried jobs, and it is only for the richest segment of the population it emerges as the unambiguously most rewarding mode of employment. This suggests that the poor face serious impediments in enhancing the return to labour from self-employment, not just in gaining access to salaried jobs.

Table IV.3

**Distribution of Household Workforce by Mode and Sector of Employment
And by Poverty Status in Rural Areas: 1999/00
(Percentages)**

Poverty Status	Farm		Non-Farm		
	Self-employment	Casual Wage labour	Casual wage labour	Self-employment	Salaried Wage labour
Extreme Poor	26.5	41.1	14.1	12.0	6.3
Moderate Poor	35.4	29.7	12.8	15.4	6.7
Moderate Non-Poor	39.7	19.6	11.0	18.1	11.6
Rich Non-Poor	42.1	9.7	7.7	23.6	18.5
<i>All Poor</i>	<i>32.0</i>	<i>34.0</i>	<i>13.4</i>	<i>13.9</i>	<i>6.7</i>
<i>All Non-Poor</i>	<i>41.1</i>	<i>15.2</i>	<i>9.1</i>	<i>20.5</i>	<i>14.4</i>
<i>All Households</i>	<i>36.2</i>	<i>25.0</i>	<i>11.2</i>	<i>17.3</i>	<i>10.2</i>

Source: Estimated from the unit records of *Household Income and Expenditure Survey, 2000*.

In order to explore the nature of impediments a bit more deeply, further comparison between the poor and the moderate non-poor in terms of their employment pattern has been made.²⁹ A note on activities in which the moderate non-poor were mostly engaged has been made and tried to find out whether the poor had any problems in engaging in those activities. Non-poor seem to face two kinds of problems.

First, there appears that some kind of entry barriers for the poor exist, especially the extreme poor, for the activities in which the moderate non-poor are mostly engaged. Thus in Table IV.4, list of activities that together account for ninety per cent of the time devoted by the moderate non-poor to productive activities was prepared and find that the extreme poor are able to devote only half as much time to such activities. Second, to the extent that the poor do engage in these activities, the return to labour per unit of time is distinctly lower for them compared to the moderate non-poor.

²⁹ The reason for taking the moderate non-poor as the comparator group is that in the short to medium term it is this group that the poor can aspire to join at best, if they are able to escape the poverty trap. As such, it is this group rather than the very rich that should be taken as the relevant comparator group for the purposes of policy-making.

Table IV.4

**Returns to Labour and the Extent of Involvement in High-Productivity Activities
by Different Income Groups: Rural Areas 1999/00**

Description of Activities	Productivity of Time (Tk/hour)			Fraction of Time Allocated to Each Activity (%)		
	Moderate Non-Poor	Moderate Poor	Extreme Poor	Moderate Non-Poor	Moderate Poor	Extreme Poor
Other Trade	12.22	10.09	7.28	26.79	25.34	8.58
Road Transport	10.34	8.54	7.40	10.13	17.87	10.64
Fishery	18.12	9.60	8.84	6.71	8.52	2.42
Food Processing	10.36	7.80	4.28	5.50	3.89	2.02
Construction	10.27	8.99	8.93	5.40	6.45	3.57
Educational Services	13.65	13.72	8.71	5.23	2.75	1.00
Cloth Production	8.50	7.55	6.52	5.05	5.09	4.40
Health & Social Welfare	9.90	6.91	4.31	4.71	1.84	1.51
Furniture & Misc. Mfg	13.21	10.34	6.95	4.48	1.09	2.80
Hotel/Restaurant	7.21	6.75	5.77	4.08	2.49	1.71
Ready-Made Garments	10.53	7.90	7.40	3.95	4.17	1.64
Public Administration	13.22	11.98	8.60	2.99	2.56	0.95
Marine Transport	10.20	6.83	7.34	1.73	1.23	1.67
Petty Trading & Repair Srvc	9.77	11.01	6.51	1.54	0.87	0.56
Wood Products	14.01	11.83	10.40	1.42	1.15	0.77

Source: Estimated from the unit records of *Household Income and Expenditure Survey, 2000*.

Thus the poor are twice disadvantaged – they are unable access fully the activities that have the potential to raise them above the poverty line and even when they do gain access to such activities they are unable to earn as much as the moderate non-poor do from the same activities. Both these disadvantages surely have a lot to do the poor’s relative lack of ability to access salaried jobs in the non-farm sector or to earn high rates of return from self-employment.

Next, the differences in the characteristics of the poor and the moderate non-poor that might account for these disadvantages have been identified. The objective is to locate more precisely the impediments that prevent the poor from gaining access to activities and modes of employment that offer a high rate of return to labour. For this purpose, those rural households among the moderate non-poor that enjoyed a relatively high return to labour were selected and compared with the poor in terms of various types of endowments – viz. human capital, physical assets (both personal and collective) and support from social network. The poor have distinctly lower endowments of all these types – indeed there is a clear downward gradation from the moderate non-poor to the moderate poor and to the extreme poor (Table IV.5).

Table IV.5

**Comparison of Endowments Among Different Income Groups:
Rural Areas, 1999/00**

Endowments	Moderate Non-Poor	Moderate Poor	Extreme Poor
A. Human Capital			
A.1 Labour Force per household			
Total no. of workers	1.70	1.60	1.59
No. of male workers	1.53	1.44	1.35
No. of female workers	0.17	0.16	0.24
Dependency ratio	2.74	2.90	3.11
A.2 Education (for average household)			
Average educational score of workers	5.86	3.28	2.68
Highest education of any worker	5.45	3.88	3.22
Highest education of any male worker	4.87	3.15	2.54
Highest education of any female worker	3.54	2.30	1.70
B. Physical Assets			
B.1 Personal Assets per household			
Present value of land assets (Tk)	12038	6858	3061
Present value of non-farm enterprises	23497	8964	1921
Market value of house	44176	23435	15035
All other non-land assets	2727	1265	477
B.2 Collective Assets (Infrastructure)			
Percentage of households with access to Electricity	25.2	11.8	3.0
C. Network Support			
Percentage of households receiving remittance from abroad	5.3	2.3	1.4
Percentage of households receiving remittance from within country	15.7	11.8	8.9

Source: Estimated from the unit records of *Household Income and Expenditure Survey, 2000*.

In terms of human capital, the poor are endowed with a smaller labour force – especially, male labour – and burdened with a higher dependency ratio. Crucially, they have much lower educational achievement – for both male and female labour. Thus, compared to the moderate non-poor, the average education of workers among the ‘extreme poor’ households is less than half and that of ‘moderate poor’ workers is only just over half. As expected, the poor have much less physical assets – both land and non-land assets. They also have less access to collective assets such as physical infrastructure – proxied in this case by access to electricity. Thus, while nearly a quarter of moderate non-poor households in rural areas have access to electricity, only 3 per cent of the extreme poor and twelve per cent of the moderate poor do so. And finally the poor also receive less support from social network in the form of remittances sent by relatives working elsewhere.³⁰

³⁰ These contrasts between the poor and the moderate non-poor also hold for urban areas, with just one exception – the poor in the urban areas have a slightly higher number of workers per household, primarily because their female members participate a lot more in the labour force.

These disadvantages in terms of endowments of various kinds can go a long way to explain why the poor are unable to escape poverty by raising the return to their labour. Thus the shortage of workers per household can dissuade them from looking for salaried jobs because poor households would tend to maintain a minimum level of subsistence production in order to minimise the risk of food insecurity. High dependency ratio can also act as a barrier even if they wanted to take up salaried jobs. More importantly, lack of education can act as a serious impediment to moving up the hierarchy of salaried employment.

Lack of education, coupled with shortage of physical assets and lack of access to physical infrastructure, can also prevent the poor from moving into highly rewarding types of self-employed activities that are capable of emancipating them from the clutches of poverty. Such activities would typically involve a somewhat larger scale of operation than the kind of micro enterprises in which the majority of the self-employed poor are engaged. But, as a recent survey shows, no more than 10 per cent of members of the Microfinance II project of PKSF – the apex body of microfinance institutions (MFIs) in Bangladesh – are even willing to take much larger loans for scaling up their operations. The possible entry barriers include poor managerial capability related to lack of education, inability to provide own equity participation needed in view of high interest cost of micro credit, and low expectations of rates of return due to poor access to infrastructural facilities.

If these barriers to scaling up the operations of small enterprises can be removed, it will be possible both to enable the more enterprising among the poor to upgrade to highly rewarding self-employed activities and to enable the less enterprising among them to escape poverty by taking up adequately remunerative salaried jobs in such enterprises.

The preceding analysis of the growth and poverty dynamics in the recent decades as well as the analysis of the impediments faced by the poor in taking advantage of economic opportunities opened up by the growth process suggest a policy package that ought to include the following elements.

First, since the lynchpin of the growth-poverty nexus was the demand-driven growth of the non-tradable sector, macroeconomic policy must do everything possible to sustain the momentum of demand expansion, without of course overheating the economy. At the very least, it should avoid unnecessary contraction of demand.

Second, the incentive structure promoted by macroeconomic policies should accelerate the growth of non-tradable non-farm activities, at least over the medium term.

Third, conditions should be created that would enable the poor to find more remunerative employment in scaled up enterprises in the non-farm sector. This would in turn require the policy regime to aim at softening at least three types of constraint: (i) education and skill of workers, (ii) physical infrastructure, and (iii) access to credit.

The conduct of macroeconomic policy in Bangladesh has been analysed in the subsequent sections in the light of these requirements of a pro-poor macroeconomic strategy.

V. MACROECONOMIC MANAGEMENT IN THE 1980S AND THE 1990S: AN OVERVIEW

For much the 1970s, macroeconomic policy was designed in Bangladesh primarily with a view to reviving a war-ravaged economy following the War of Liberation in 1971 within an overall framework of extensive state control. A major change of direction occurred in the early 1980s with the adoption of market-oriented liberalising policy reforms known as structural adjustment. These reforms were initiated against the backdrop of serious macroeconomic imbalances. The beginning of the 1990s saw the launching of a more comprehensive programme of macroeconomic reforms, which coincided with a transition to parliamentary democracy from a semi-autocratic rule. While the macroeconomic restructuring has had considerable success in stabilising the economy, the long-awaited transition from stabilisation to growth has yet to gather pace, although some beginnings appear to have made towards that end in the last decade.

The reforms of the 1980s, undertaken along the guidelines of the World Bank and the IMF and implemented under fairly rigid aid conditionality, were aimed at reducing the fiscal and external deficits to a sustainable level, consistent with the reduced level of aid availability.³¹ The trends in various macroeconomic indicators over the last two decades are shown in Table V.1. It can be seen from this Table that there was some success in reducing both fiscal and external deficits in the second half of the decade – the fiscal deficit came down from 6.6 per cent of GDP in the first half of the decade to 5.4 per cent in the second half, while trade deficit came down from 8.9 per cent to 7.2 per cent. But this success was achieved at some cost. The macroeconomic balances were improved not so much by raising revenue or exports, but by squeezing expenditure on the fiscal front and imports on the external front. Thus, between the two halves of the decade, the tax-GDP ratio barely increased, while development expenditure as a percentage of GDP declined from 6.6 per cent to 5.4 per cent. Similarly, export revenue as a percentage of GDP barely increased, while the import-GDP ratio declined from 14.3 per cent to 12.8 per cent. Thus as in the case of most other early experiments in structural adjustment, the attempt to achieve macroeconomic stabilization in Bangladesh was made along the contractionary route. The evidence of contractionary pressure is seen in the excess of domestic savings over investment and in the decline in import-GDP ratio despite a stable export-GDP ratio. Such a situation was clearly unsustainable over the longer-term.

The problem was compounded by continuing decline in the flow of foreign aid and by poor budgetary management. While development expenditure was squeezed, the government failed to maintain a hold on current expenditure. Throughout the 1980s, the contribution of the government's fiscal operations to domestic savings, in the form of public savings, continuously declined because of the rapid growth in current expenditures along with a stagnant revenue-GDP ratio. As a result, macroeconomic strains started to reappear towards the end of the decade (Mahmud 2001a).

³¹For a discussion on these reforms and the macroeconomic developments in the 1980s and the 1990s, see Task Forces (1991), Rahman (1992) and Mahmud (1995, 2001a).

Table V.1

Macroeconomic Performance of Bangladesh 1980/81 – 1999/00:
(All figures are in percentages of GDP)

	80/81-84/85	85/86-89/90	90/91-94/95	95/96-99/00
<i>Investment and Savings</i>				
Gross Investment	16.93	16.55	17.92	21.50
Public	4.83	6.13	6.67	6.77
Private	12.10	10.42	11.25	14.73
Gross domestic savings	7.99	9.40	12.54	15.30
Gross national savings	10.66	12.34	15.46	18.86
<i>Government Budget</i>				
Total revenue	6.3	6.7	8.8	9.2
Total expenditure	12.9	12.2	13.8	13.6
Budget deficit	6.6	5.6	5.0	4.5
<i>Monetary Sector</i>				
Broad money supply	15.72	20.67	25.24	28.74
<i>External sector</i>				
Exports of goods and services	5.42	5.60	7.16	11.08
Imports of goods and services	14.34	12.76	12.60	17.28
Trade openness	19.76	18.36	19.76	28.36
Trade deficit	8.94	7.16	5.38	6.20
Workers' remittances	2.66	2.95	2.91	3.56
Debt service	0.64	1.02	1.07	1.15
Outstanding debt	28.14	35.97	39.44	34.67

Notes and sources:

- (1) GDP figures are from BBS (2000, 2001a).
- (2) The annual budgetary figures are from the statistical appendices of World Bank (1991, 1995) and GOB (2002).
- (3) Exports and imports refer to both goods and services. The annual figures are from BBS (2001, annex table 12) and GOB (2002, annex table 1.2).
- (4) Trade openness is defined as the sum of exports and imports as a percentage of GDP.
- (5) Trade deficit is defined as imports minus exports.
- (6) Figures for workers' remittance are from GOB (2002, annex table 44) and WB (1991, annex tables 3.1 and 3.2). Dollar values were converted into taka by using the exchange rates given in GOB (2002, annex table 41) and WB (1991, table 3.1).
- (7) Gross investment figures are from BBS (2001a, annex table 12) and GOB (2001a, annex table 1.2).
- (8) Gross domestic savings have been estimated as gross investment minus (the absolute value of) trade deficit. Gross national savings have been estimated as gross domestic savings plus workers' remittances.
- (9) Figures on money supply are from *Statistical Yearbook of Bangladesh*, various years.

The policy reforms in the 1980s included mainly the withdrawal of food and agricultural subsidies, privatisation of state-owned enterprises, financial liberalisation, and withdrawal of quantitative import restrictions. The reforms of the early 1990s were particularly aimed at moving towards an open economy – such as making the currency convertible on the current account, reducing import duties generally to much lower levels, and removing virtually all controls on the movements of foreign private capital. Besides, fiscal reforms were undertaken including the introduction of the VAT.

The launching of the wide-ranging policy reforms in the beginning of the 1990s was followed by some positive developments in the macroeconomic indicators. There was a marked improvement in the government's budgetary position along with an equally marked increase in the domestic saving rate (Table V.1). However, the increase in the saving rate was not matched by a commensurate response from private investment, at least in the early 1990s. Private investment as a proportion of GDP did go up in the first half of the 1990s as compared with the late 1980s, but not by enough to match the savings effort. Things did begin to change, however, in the second half of the decade when further increase in the savings effort was well-matched by increased private investment, while public investment remained more or less stable as a proportion of GDP. As a result, the overall investment rate – which was stuck between 16.5 and 18 per cent during the period from 1985 to 1995 – rose to 21.5 per cent in the second half of the 1990s paving the way for superior growth performance in this decade.

All this was achieved along with remarkable success in keeping inflation under control. In the first half of the 1980s, the rate of inflation was ominously high at 13 per cent. It is only the contractionary effect of structural adjustment of that period that brought inflation down – to around 8 per cent in the second half of the decade. The 1990s saw further decline in the inflation rate – down to 5.6 per cent in the first half of the decade and 5.8 per cent in the second, and this time the reduction was achieved despite relative buoyancy of the economy compared to the preceding decade.

There are, however, certain disconcerting features in the macroeconomic indicators that deserve attention. First, whenever there seems to be an upturn in investment and industrial activity levels, it comes against the balance of payments constraint leading to a depletion of foreign exchange reserve. This was true of the mini boom that took place around 1994/95. Although there was a slight increase in the rate of inflation as well, the persistent problem seems to be that of the external balance rather than of the aggregate resource balance (that is the savings-investment balance). This is more evident in a later episode of upturn in manufacturing growth associated with expansion of private sector credit and high growth in the import of capital goods. This was in 2000/01; the domestic inflation rate in fact declined in that year, but the foreign exchange reserves came down to a critically low level. This phenomena is reminiscent of a dominant trade gap in the erstwhile popular two-gap model of foreign aid. It reveals the highly import-intensive nature of investment and manufacturing activities in Bangladesh. Most capital machinery is imported (which makes such imports a proxy for investment) and domestic manufacturing is highly dependent on imported raw materials and intermediate goods. As a result, in spite of very impressive export growth, the balance of payments remain fragile, as will be further elaborated later. An important implication is that, the growth of the 'formal' or large-scale part of manufacturing (whether export-oriented or import-substituting), may contribute more to pro-poor growth indirectly by maintaining the balance of payments than directly by providing employment to the poor.

Second, the determinants of domestic saving mobilization are poorly understood. The most visible source of increased domestic savings in the early 1990s was the significant improvement in the government's budgetary position resulting in higher public savings. Revenue earnings as a proportion of GDP increased by about 2.5 percentage points of GDP between 1989/90 and 1992/93, while proportion of current spending was kept from rising. That was evidently a remarkable fiscal development representing a reversal of the earlier trends. The impressive revenue growth, however, turned out to be a once-and-for-all phenomenon with the tax-GDP ratio and the revenue surplus remaining nearly unchanged

since the mid-1990s. There was also some increase in the saving rates in the later part of the 1990s, but there are uncertainties about these estimates. The investment estimates, from which the saving estimates are derived, suffer from methodological and data deficiency. Also, in the recent years, the official estimate of export earnings is suspected to have had an increasingly upward bias, thus resulting in a possible underestimation of the external current account deficit. This would create an upward bias in the saving estimates as well, increasingly so for the later years.³²

Third, while lower inflation in the 1990s compared to the pre-reform period is a positive indicator of macroeconomic stabilisation, a near-zero inflation rate may be symptomatic of demand deficiency leading to capacity under-utilisation. Targeting for a too low inflation rate through restraint on credit and monetary expansion can sometime result in the overkill, since one cannot be sure whether this will result in a recessionary situation in some parts of the economy. Production contraction can then happen if prices are not flexible downward, which may be the case not only for industrial production but also for many subsistence type activities where the price (of the service or the product) may be determined somewhat inflexibly like the so-called subsistence wage. It is noteworthy that in some years, the price indices of domestically produced industrial goods were as low as about 1 percent. This would mean a hit or miss situation if the aim is not to adversely effect capacity utilization in the presence of downward inflexible prices. Yet another problem with pushing inflation too low is that it will make it difficult to bring about the large relative price changes that the structural adjustment policies aim at, given the existence of downward rigidity of wages and prices. Maintaining an appropriate external and aggregate supply-demand balance also needs a skilful blending of monetary, fiscal and exchange rate policies, the capacity for which is hardly available in the government's policymaking organs.

³² The official estimate of export earnings is from the data of the Export Promotion Bureau and the Bangladesh Bank's balance of payments estimates are reconciled by including an 'errors and omissions' figure.

VI. FISCAL POLICY AND PUBLIC EXPENDITURE

VI.1 The Budgetary Trends

The market-oriented policy reforms that Bangladesh undertook in the last two decades involved a redefining of the developmental role of the government and the priorities of public expenditures. The fiscal measures included reduction or elimination of agricultural and food subsidies during the late 1980s, introduction of VAT in the early 1990s, and a gradual withdrawal of direct public investment in productive sectors. The envisaged developmental role of the government was mainly defined in terms of the provision of such public goods as education, healthcare, public utilities and physical infrastructure. In addition, this role also included the implementation of cost-effective poverty-alleviating programs to provide 'safety nets' for the poor. The evolving size and structure of government budget reflect these changes.

One serious problem in analysing the budgetary trends is that the realised expenditures and earnings may be substantially different from the figures given in the original budget documents or even in the "revised" budgets prepared at the end of the financial year. A comparison of the actual and the original budget figures shows a typical pattern: that there is some shortfall in revenue collection and in foreign aid disbursements, and excess in revenue expenditure. The effect of this is borne by a downsizing of the development expenditure (in some years, substantially) and by an unanticipated extent of domestic borrowing.

The annual budget has two components: (a) the current or revenue budget that is meant to meet the regular expenditures on public administration and defence as well as the recurrent expenditures in social sectors like health and education, and (b) Annual Development Plan (ADP) that includes project-wise allocations for development spending. While the larger part of expenditure under ADP can be called public investment (in the strict economic definition of physical investment, i.e. construction and installation of equipment), it also includes expenditures that are more in the nature of public consumption. The demands for current budget are matched against revenue income, and any surplus is available for financing the ADP. The ADP expenditure, net of this revenue surplus, shows the overall budgetary deficit, which is financed by net foreign aid.³³ Any remaining deficit is met by the government's domestic borrowing, consisting of bank borrowing and sale proceeds of government saving certificates and bonds.

Budgetary trends for the last two decades, based on revised budget estimates are presented in Table VI.1. All the estimates are shown as proportion of GDP at current market prices. A number of trends are worth noting.

First, fiscal operations of the government had to be defined in the context of a steadily declining availability of foreign aid. The decline has been particularly rapid in the 1990s. From over 5 per cent to GDP in the second half of the 1980s, foreign financing came down to only 2.6 per cent of GDP in the second half of the 1990s.

Second, the challenge posed by reduced availability of foreign aid has been met not by reducing expenditure, but partly by improved revenue effort and partly by increased domestic borrowing. Thus, as a proportion of GDP, total government expenditure increased slightly

³³Foreign aid net of amortisation; payments of interest on foreign concessional loans are included in the revenue budget.

from 12.9 per cent to 13.6 per cent in the last two decades. This was supported by a rising revenue-GDP ratio, which went up from 6.3 per cent to 9.6 per cent, and increased domestic borrowing, which went up from 1 per cent to 1.9 per cent of GDP.

Table VI.1
Summary of Government Budget
(As percentages of GDP)

	80/81-84/85	85/86-89/90	90/91-94/95	95/96-99/00
Total revenue	6.3	6.7	8.8	9.2
Tax revenue	5.2	5.4	7.0	7.5
Current expenditure	4.6	6.0	6.7	7.3
Revenue surplus	1.7	0.7	2.1	1.9
Development expenditure	6.6	5.4	5.4	5.9
Total expenditure	12.9	12.2	13.8	13.6
Budget deficit	6.6	5.5	5.0	4.4
Domestic borrowing	1.0	0.5	1.2	1.9
Foreign financing	5.6	5.0	3.8	2.5

Notes and sources:

1. GDP figures are from BBS (2000, 2001a).

2. The annual budgetary figures are from the statistical appendices of World Bank (1991, 1995) and GOB (2002).

Third, of the two broad components of government expenditure – current and development – it is the current expenditure that has risen over the last two decades – from 4.6 per cent to 7.3 per cent of GDP. The increase was particularly sharp in the second half of the 1980s (which was the tenure of the semi-autocratic regime of General Ershad); since then the rise has been much more restrained. The transition to a democratic regime thus seems to have resulted in increased accountability in respect of restraining the government's current expenditures. There are, however, signs that the restraining effect has weakened considerably in the very recent years resulting in a fresh upsurge in current expenditure.

Fourth, partly because of the sharp increase in current expenditure in the second half of the 1980s, the size of development budget as a proportion of GDP actually declined in that period. Better management of the revenue budget in the subsequent years allowed a slight increase in this proportion, but it never fully recovered – falling from 6.6 per cent in the early 1980s to 5.9 per cent in the late 1990s.

Finally, despite the obvious strains put on the budget by rising current expenditure, the overall budget deficit has not been allowed to get out of control. Indeed the general trend is clearly downward – from around 6.6 per cent of GDP in the early 1980s budget deficit came down to 4.4 per cent in the late 1990s. An even sharper decline – which would have resulted in further squeezing of development expenditure – was avoided by the government's willingness to take recourse to increased domestic borrowing in response to declining foreign financing.

Overall, these trends indicate that ever since the latter half of the 1980s, fiscal policy has not been used aggressively as a tool of aggregate demand management, in either direction. The loss of foreign aid posed a serious danger in the 1990s of leading to a contraction in demand by forcing the government to trim down its expenditures drastically, but the danger was minimised by resorting to increased domestic borrowing. At the same time, however, increased borrowing was not allowed to result in a reckless expansion in demand, as budget deficit was actually brought down a little and inflation kept under control. Fiscal policy thus played the useful role of averting a potential contraction in demand, without however leading to excess demand in the process of doing so. This helped create a reasonably stable macroeconomic environment, which allowed the real side of the economy to sustain modest growth acceleration, leading to reduced poverty, through the growth-poverty nexus described in section IV. A sharp rise in budget deficit in recent years (1999/00 - 2000/01) has raised fresh questions about the soundness of macroeconomic management. How these questions are resolved and what effect that resolution will have on aggregate demand may have important repercussions on the dynamics of growth and poverty reduction in Bangladesh in the coming years. These issues are discussed later in this section, after reviewing the policy of budgetary allocations to different sectors of the economy.

VI.2 Sectoral Allocation of Public Resources

The sectoral allocation pattern of development spending has undergone some significant changes in the last two decades, reflecting the changing developmental role of the government under the economic reforms (Table VI.2).³⁴ Allocations have fallen appreciably for a number of sectors – most notably, manufacturing industry, water resources, and energy, and agriculture. Allocations to manufacturing industries have been reduced to almost an insignificant proportion, showing that the government has virtually withdrawn from investment in setting up new industries. With the rapid expansion of tube-well irrigation in the private sector, the proportion of allocations to water resource development has also declined. Also, the decline in investment in energy reflects increased reliance on private companies for the generation of electricity and for the exploration activities. The reverse of this structural change in development spending is the increased proportional allocations to transport and communication, rural development and to social sectors, especially education.

Broadly speaking, one finds a close concordance between the accepted development strategy and the patterns and trends in public expenditures. The government is rapidly withdrawing from the directly productive sectors and concentrating more on providing public goods in the form of education and health, physical infrastructure, and rural development.³⁵ Two points, however, may be made at this stage regarding the above restructuring of development spending. First, how far higher allocations to the social sectors will lead to an improvement in social development indicators will depend very much on the quality and effectiveness of the spending. The *a priori* rationale and the actual effectiveness of public expenditures are two separate aspects. There is also broader question of whether redefining government's role, as reflected in the budget, will result in the envisaged private-sector-led growth that is also pro-poor. Second, the structural shift in the budget towards larger social spending has come about from a redefining of the role of the government and is, therefore, of a once-and-for-all nature. In future, higher allocations to social sectors will require more difficult reforms, for example,

³⁴ For more on the allocation and efficiency of public expenditure, see Mahmud (2002).

³⁵ The food for work programme, which is a major poverty-alleviating programme in Bangladesh, is not included in the Development Plan and is not therefore shown in Table VI.2. In spite of declining volume of food aid, the government has continued, and even expanded this programme.

in respect of preventing tax evasion or any downsizing the government. This point has been discussed below. But first public expenditure on health and education – which are intrinsically relevant for reducing human poverty and also instrumentally important for reducing income poverty - has been analysed.

Table VI.3 shows the trends in public expenditure on education and health (including family planning) as shares of total budget expenditure (development and revenue budgets combined) and Table VI.4 shows them as percentages of GDP. These tables show that the proportional allocation of education and health has continuously increased all throughout reform period beginning from the early 1980s. Their combined share of total budgetary expenditure has gone up from 14 per cent to 23 per cent during this period. The increase has been particularly rapid for education, whose share has doubled from 8 per cent to 16 per cent, while the share of health and family planning has increased from 5 per cent to 7 per cent.

It is remarkable that even when total budgetary expenditure declined as a proportion of GDP, as in the second half of the 1980s, the shares of these two sectors were not allowed to fall, and they continued to rise throughout the 1990s. This has resulted in a rising proportion of GDP being allocated to these two sectors. Currently, these sectors amount to about 3 per cent of GDP, up from 1.7 per cent in the early 1980s.

Table VI.2
Sectoral Shares in Development Expenditure
(Percentages)

	80/81-84/85	85/86-89/90	90/91-94/95	95/96-99/00
Agriculture	13.09	5.48	5.93	4.72
Rural Development	3.51	2.59	5.40	9.14
Water Resources	13.99	12.63	8.76	7.16
Industry	9.57	11.60	1.59	1.24
Energy	21.87	23.33	17.74	17.08
Transport & Communication	15.34	10.71	18.82	21.96
Physical planning & housing	5.32	3.77	5.48	5.50
Education	3.97	4.40	8.14	13.08
Health and Family Planning	5.18	4.71	7.73	8.04
Others	7.47	17.45	21.60	12.10
Total	100.00	100.00	100.00	100.00

Notes and sources: The annual figures are from the statistical appendices of World Bank (1991, 1995) and GOB (2002).

Table VI.3
Government Expenditure on Health and Education
(As shares of the budget)

	80/81-84/85	85/86-89/90	90/91-94/95	95/96-99/00
<i>% of Current Expenditure</i>				
Education	14.32	17.07	18.40	18.58
Health & Population Planning	5.06	5.47	6.02	5.84
<i>% of Development Expenditure</i>				
Education	3.78	5.23	8.58	12.13
Health & Population Planning	5.63	6.46	7.57	8.57
<i>% of Total Expenditure</i>				
Education	8.16	11.24	13.62	15.51
Health & Population Planning	5.40	5.88	6.77	7.13

Notes and sources: The annual figures are from the statistical appendices of World Bank (1991, 1995) and GOB (2002).

It is, however, one thing to allocate more resources to health and education and quite another to ensure that the poor actually receive their due share of these resources. In order to judge whether public expenditure policy is pro-poor or not, it is necessary to conduct benefit incidence analysis for different income groups. Some recent studies have attempted to do this, using detailed household level information contained in the HIES of 1999/00. The relevant information on education and health are provided in Tables VI.5 and VI.6 respectively.

Table IV.4
Government Expenditure on Health and Education
(As percentage of GDP)

	80/81-84/85	85/86-89/90	90/91-94/95	95/96-99/00
<i>Current Expenditure</i>				
Education	0.73	1.03	1.23	1.33
Health & Population Planning	0.26	0.33	0.40	0.42
All	5.06	6.08	6.70	7.17
<i>Development Expenditure</i>				
Education	0.27	0.30	0.57	0.78
Health & Population Planning	0.41	0.36	0.49	0.55
All	7.22	5.74	6.48	6.44
<i>Total Expenditure</i>				
Education	1.00	1.33	1.81	2.11
Health & Population Planning	0.66	0.70	0.90	0.97
All	12.28	11.82	13.18	13.61

Notes and sources: The annual figures are from the statistical appendices of World Bank (1991, 1995) and GOB (2002).

The first point to note is that private expenditure on education and health – especially, education – is much more skewed than overall private expenditure. That is, the poorer groups spend not only lower absolute amounts on health and education, they also spend proportionately less than the richer groups. Obviously, greater subsistence pressure prevents the poor from incurring the necessary expenses. This makes it all the more necessary that public expenditure policy is used in a pro-poor manner, channelling proportionately more resources to the poorer groups. The expenditure policy of the government of Bangladesh is ostensibly mindful of this imperative.

Table IV.5
Distribution of Expenditure on Education

	By quintile (ascending order)					By poverty status	
	1	2	3	4	5	Poor	Non-poor
Per capita expenditure	8	12	16	22	42	26	74
Private education spending	3	7	12	25	52	15	86
Public education spending	12	15	17	23	32	35	65
Primary education	22	23	22	19	14	56	44
Secondary education	6	11	16	28	40	24	76
Tertiary education	6	6	10	21	57	17	83
Food for Education							
Wheat	35	29	17	14	5	67	33
Rice	30	36	12	17	6	72	20
Female Secondary Stipend	7	14	19	29	32	30	70

Source: World Bank (2002a), p.49.

Table IV.6
Distribution of Expenditure on Health

	By quintile (ascending order)					By poverty status	
	1	2	3	4	5	Poor	Non-poor
Per capita expenditure	8	12	16	22	42	26	74
Private medical costs	7	8	15	18	52	20	80
Public health spending	16	19	21	18	26	45	55
Family planning and Control of curative diseases	18	18	19	19	24	46	54
Curative care	11	21	22	18	28	42	58
Maternal health	20	13	20	18	29	44	56
Child health	23	21	19	18	18	54	46

Source: World Bank (2002a), p.55.

Bangladesh has a centralised system of financing education through revenue and development allocations in the national budget. The government finances all primary schools including non-government ones, but parents are required to contribute towards construction of school facilities and maintenance activities³⁶. The primary school teachers are paid out of national budgets and are not accountable to any local representative bodies; as such, they constitute in effect a multitude of centrally supervised permanent functionaries of the government. Although most of the secondary schools are privately managed, they depend on the government for most part of their operating and capital expenditures. All higher and tertiary education is primarily run through government grants, although the private sector's participation has been on the increase in recent years.

With considerable progress made in primary education in Bangladesh, the enrolment gap between rich and poor has been considerably narrowed and the gender gap has been eliminated. In fact, female enrolment is as high as or even higher than male at all levels of education below the higher secondary, which is a truly remarkable achievement. The rich-poor gap, however, widens rapidly from the junior secondary level and upward. Also, while there are no significant rural-urban disparities in enrolment at the primary level, these disparities do exist against rural areas at the secondary level and above.

The implication of this enrolment pattern is that public expenditure on primary education is found somewhat pro-poor, in the sense that the poor receive a greater share of the benefit. The food for education (FFE) programme which was instituted to entice the parents of poor households to send their children to primary school also has a strongly poor-poor bias. However, this pro-poor bias needs to be put into perspective. In theory, the amount of subsidy accruing to different population groups depends on three factors – viz. the number of potential users, the rate of use among the users, and the level of per-user subsidy. In the case of primary education, the number of potential users is determined primarily by the demographic composition. As it happens, because of differences in fertility pattern, 3 out of 5 children in the primary age group come from poor households. On the other hand, the rate of use (enrolment rate) is lower among the poor, while the rate of per-user subsidy does not vary much for different income groups. Therefore, the key factor driving the pro-poor distribution of primary education is the age composition, which more than offsets the lower enrolment among the poor.

Furthermore, the pro-poor bias reverses sharply at higher levels of education. Thus while some 56 per cent of public spending on primary education goes to the poor, only 24 per cent of spending on secondary education and 17 per cent of tertiary education do so. The overall public spending on education does not therefore have the pro-poor property.

One redeeming feature, however, is that even for overall spending on education, the distribution of benefit is less unequal than the existing distribution of private income and expenditure. Public spending on education can thus be described as weakly pro-poor in the sense that it tends to reduce overall inequality. The second redeeming feature is that most government expenditure is directed to primary and secondary education, which currently claims about 85 percent of total education budget (recurrent and development expenditures combined)³⁷. The expenditure priorities thus seem to be broadly consistent with the equity criteria and the objective of achieving basic literacy among the population.

³⁶Only the non-registered private primary schools, including community and satellite schools and some religious schools are not publicly financed.

³⁷The allocations for primary education are slightly higher than those for secondary education.

However, the broad pattern of educational expenditure conceals some major inefficiencies of the education system. One major concern pertains to the efficiency of the flagship programme of FFE. Early evaluation of the programme showed promising results in terms of promoting enrolment and reducing dropout rates (Ahmed 2000). Also, the level of leakage was found to be low (7 per cent). However, since the programme is now claiming a very large share (above 40 per cent) of the funding for primary education under the development budget, questions have been raised about the priorities of resource needs in this sector. More recent studies suggest that the cost of income transfer under the programme may have increased and the targeting may have deteriorated with the expansion of the coverage (World Bank 1997, 2002b).

A related problem of inefficiency arises from the government's apparent preference for expanding the physical facilities and enrolment at all levels at the cost of sacrificing the quality of education. In spite of a remarkable success in increasing primary level enrolment and in achieving gender parity, the quality of education is alleged to have sharply fallen. In this situation, the government has opted for extending primary education from five to eight years in defining the goal of universal primary education. This is a wasteful but easier option than taking steps for improving the quality of the existing primary education system. The latter would require putting in place mechanisms for making the primary school teachers accountable and for disciplining them for deviant behaviour (e.g. frequent abstention and negligence of duty). But these teachers, being under a centralised administrative structure, constitute a powerful and influential constituency, which no government would like to antagonise.

Yet another source of concern lies in the fact that rapid expansion of generalist higher education has perhaps been of very little social benefit, given the extremely inadequate teaching and other facilities and the consequent low quality of output (Mahmud 1994)³⁸. The higher degrees, whatever their worth, are used as a "credential" for securing higher-paying white-collar jobs. This characteristic of the white-collar job market, combined with demographic pressure and cultural preferences, results in heavy social demand for publicly subsidised higher education.

There are other aspects of the higher education strategy that involve inefficiencies, inequities and an urban-middle-class bias. The public funding of higher education benefits a narrow segment of population, mostly sons and to lesser extent daughters of urban middle class. There is no economic rationale for providing higher education virtually free of cost in colleges and universities, particularly for non-technical education. Such education has very little "public good" characteristics and students predominantly come from non-poor families.

The distribution of public expenditure on health shares some characteristics with expenditure on education. As the data in Table VI.6 show, government's overall health expenditures were not pro-poor *per se*, but only weakly pro-poor in the sense that these expenditures were more equitably distributed compared to distribution of household income or expenditure in the economy. In other words, public health spending helps to *reduce* overall inequality in economy, although it is itself skewed against the poorer households. It is, however, important to note that one particular component of health spending, namely, child healthcare within the

³⁸ The rate of return from general college education, even when estimated in terms of *private* benefit from increased income prospects, are found to be quite low in Bangladesh - lower than 10 percent; see Mahmud (1981). Given the low quality of such education, the social benefit in terms of contributing to increase in productivity, would be even lower.

so-called essential services package (ESP) is found to be *strongly* pro-poor (that is, skewed in favour of the poor)³⁹.

Why don't the poor have better access to public health resources? Bangladeshis generally seek infrequent curative health care in government health facilities⁴⁰. The resulting utilisation rates of government facilities are quite low, representing wastage of scarce resources. Although fees charged in government facilities are low, informal fees required, particularly to get quality services, can be a burden for the poor. Government doctors routinely engage in private practices, where they charge fees that are affordable only by the relatively rich households. This not only adversely affects the quality of public health services, but also diverts services of government doctors (including publicly financed medical equipment and other supplies) away from intended beneficiaries. If this effect were taken into account, incidence of the distribution of benefit of public health spending would be worse than found in above studies. The social benefit from public health spending is thus greatly compromised by poor governance of the public health facilities.

Clearly, ensuring adequate access of poor to education and health services of sufficient quality and quantity requires much more than allocating more budgetary resources to these sectors. Nonetheless, to give credit where it is due, it must be acknowledged that public expenditure policy of Bangladesh deserves credit for raising share of these sectors in total budget, and also for imparting at least a weakly pro-poor stance to the distribution of benefits. Although there is sufficient room towards improving pro-poor bias of these services, it is fair to say that neither equity aspect of resource allocation within these sectors nor the allocation of budgetary resources to these sectors is a major cause for concern at this stage.

There is, however, a major concern, and it has to do with absolute size of resources devoted to health and education. As can be seen from Table VI.7, per capita public expenditure on health and education in Bangladesh is much lower even by South Asian standards. Sri Lanka is of course an exceptional country in this regard, but even India devotes a much larger absolute amount. This is a reminder of the fact that the scarcity of resources, arising from the low levels of per capita income and of public spending generally is a major limiting factor in improving education and health of the poor in Bangladesh. The same goes for public spending on other expenditures, such as infrastructure that are essential for inducing a pro-poor growth. The issue of overall scarcity of resources has to be addressed through growth. Meanwhile, however, there is the question of how to increase the size of overall public spending given constraint of resources i.e., how can government mobilise more of the available resources in a manner that does not compromise future availability resources through economic growth. This is currently the most important challenge on the fiscal front for any pro-poor macroeconomic policy in Bangladesh.

³⁹According to these estimates, the poorest 20 percent of the population claim about 16 percent of the public spending on health (and 10 percent of curative health spending), and the poorest 50 percent get an estimated 45 percent. The position of the poor may be actually worse, since these estimates do not take into account the possibility that the poorer people get lower quality services and may have to pay higher extra charges. These estimated targeting outcomes fall in the middle of the recorded outcomes in other developing countries; better than Ghana and Vietnam, similar to India and worse than Malaysia; see World Bank (2002).

⁴⁰ Only 16 percent of all health visits of the urban poor are to government providers (11 percent for the non-poor); the corresponding figure for the rural poor is only 8 percent (and for non-poor, 12 percent); cited in World bank (2002).

Table VI.7**Per capita Spending on Education and Health
In South Asian Countries
(US dollars)**

	1997	1998	1999	2000
India	15	16	15	19
Pakistan	15	14	13	12
Sri Lanka	32	34	33	35
Bangladesh	11	11	11	12

Source: World Bank (2002b), p.5.

VI.3 Resource Mobilisation and Budget Deficits

Part of the reason why budgetary expenditures are low in absolute terms is of course that the resource base is low given a low per capita income. But even as a proportion of GDP, budgetary expenditure is low in Bangladesh, even by South Asian standards. Thus, in the year 2000/01, total public expenditure was just 15 per cent of GDP in Bangladesh, as compared with 20 to 30 per cent in India, Pakistan and Sri Lanka.

Low level of expenditure is in turn explained by very low revenue effort. As previously noted, there was an appreciable improvement in revenue collection in the 1990s. But in spite of that, the revenue-to-GDP ratio remains very low by international standards. Even within the sub-continent, the revenue-to-GDP ratios of Pakistan (15 Per cent), India (17 per cent) and Sri Lanka (19 per cent) exceed that of Bangladesh (10 per cent) by a wide margin. Particularly appalling is the state of direct taxation, which accounts for just 15 per cent of total revenue and 1 per cent of GDP (Tables VI.8 and VI.9). An analysis of the trends in tax yields suggest that the tax system is highly income-inelastic, so that the rate of growth of tax revenue tends to fall behind that of GDP unless discretionary measures are taken for enhancing the rate structure and/or expanding the tax base. A large and increasing degree of tax evasion is alleged to be the major factor behind this tax inelasticity (Mahmud 2001). It is a fair assumption that development spending, being the more flexible part of budget expenditures, bears the major burden of any resource shortfall. Since at least a part of development spending – especially, the part devoted to social sectors – is evidently pro-poor, the weakness in tax collection clearly acts as a serious constraint to the expansion of pro-poor spending.

Table VI.8**Structure of Taxes in Bangladesh 1986/87 – 1999/00:
(as percentages of GDP in current prices)**

	86/87-89/90	90/91-94/95	95/96-99/00
Direct taxes	0.92	1.22	1.15
Income tax	0.82	1.15	1.05
Land tax	0.10	0.08	0.10
Indirect taxes	4.58	5.58	6.26
Sales tax/VAT	0.64	2.20	3.44
Customs duties	2.09	2.28	2.20
Excise duties	1.49	0.64	0.10
Others	0.37	0.47	0.52
Total tax revenue	5.50	6.81	7.41
Non-tax revenue	5.62	1.64	1.82
Total revenue	6.55	8.45	9.23

Source: GOB (2002), annex table 13.1, for estimates of revenue; and BBS (2000, 2001a) for GDP estimates.

Greater effort at resource mobilisation, will, therefore, have to form the cornerstone of any strategy to promote pro-poor fiscal policy. A lot of this effort will have to be directed at improving institutional and administrative apparatus of tax collection and ensuring transparency and simplicity in tax laws, which fall outside the purview of macroeconomic policy *per se*. However, there are a number of macroeconomic issues that are exceedingly relevant in this context and deserve some scrutiny like the effect of external sector reforms on tax revenue; the size and financing of budget deficit, and financing of state-owned enterprises (SOEs) and the related issue of privatisation.

Table VI.9**Structure of Taxes in Bangladesh 1986/87 – 1999/00:
(as share of total tax revenue in current prices)**

	86/87-89/90	90/91-94/95	95/96-99/00
Direct taxes	16.78	17.99	15.54
Income tax	14.98	16.84	14.17
Land tax	1.80	1.14	1.39
Indirect taxes	83.22	82.01	84.46
Sales tax/VAT	11.63	31.27	46.38
Customs duties	37.98	33.68	29.67
Excise duties	27.05	10.27	1.41
Others	6.73	6.79	6.99
Total tax revenue	100.00	100.00	100.00

Source: GOB (2002), annex table 13.1, for estimates of revenue; and BBS (2000, 2001a) for GDP estimates.

As part of overall economic reform, Bangladesh launched a programme of trade liberalisation in the 1980s and strengthened it further in the early 1990s. Several implications of these reforms for growth and poverty reduction have been discussed in section VIII. For the present, the concern is with the effect on revenue collection of one very important component of this programme – namely, reduction of import duties. Since most developing countries, including Bangladesh, rely heavily on import duties for mobilising government revenue, there is a presumption in much of the literature that import liberalisation through tariff cuts can potentially have an adverse effect on the ability of governments to undertake essential public expenditures. What is the experience of Bangladesh in this regard?

As can be seen from Table VI.10 revenue from import duties has continuously declined as a proportion of the total value of imports. This decline has been entirely due to reductions in the rates of protective duties (that is, customs duties).⁴¹ However, a couple of redeeming features are worth noting. First, a great deal of tariff reforms did not lead to any effective reduction in duties, because of widespread prevalence of tariff redundancy ('water in tariff'). Second, any effect of reduced rates of duty was compensated partly by the tariffication of quotas and partly by an upsurge in the volume of imports following trade liberalisation, both of which served to expand the base of revenue collection. As a result, revenue from import duties as a proportion of GDP did not decline, and even slightly increased in years of high import growth.

It nonetheless remains true that customs duty, as a proportion of total tax revenue, has declined over time following trade liberalisation. From 38 per cent in late 1980s, it declined to 34 per cent in the first half of the 1990s and further to 30 per cent in the second half. It is important to emphasise however, that mere evidence of a reduction in revenues from customs duties is not sufficient to conclude that trade liberalisation has adversely affected the revenue effort of the government. In theory, trade liberalisation does not necessarily entail loss of revenue from imports (even leaving aside the possibility of an expanding tax base following tariffication of quotas and increase in import volume). What liberalisation requires is the elimination of protective duties i.e., duties that discriminate against imports. This is perfectly consistent with the imposition of a tax that is neutral between imported and domestic goods. Such a tax would continue to raise revenue from imports – as well as from domestic goods – while liberalisation is undertaken.

Therefore, if a government is concerned about the revenue effect of trade liberalisation, it has the option of imposing such a neutral tax. Bangladesh did precisely that by introducing the VAT in 1992 to be applied uniformly on domestic and imported goods. On the domestic front, it replaced the old-style excise duties, and on the import front it (partly) replaced customs duties and sales tax on imports. Another potential tax instrument for sustaining revenue effort while reducing protective tariffs is provided by the so-called Supplementary Duty. Like the VAT, it is meant to be imposed equally on import and domestic production; and it can also be selectively imposed on relatively inessential items of consumption.

As a result of these tax reforms, the overall collection of indirect taxes did not actually suffer in Bangladesh following trade liberalisation. As a proportion of GDP, total revenue from indirect taxes actually increased from 4.6 per cent in the late 1980s to 5.6 per cent in the first half of the 1990s and further to 6.3 per cent in the second half of the decade (Table VI.8). Therefore, if Bangladesh has done poorly in respect of revenue collection in comparison with

⁴¹ The proportion of protective duties as estimated here should not be taken to represent the average nominal rate of protection, since these estimates reflect the effect of many duty exemptions well as of tax evasion.

other countries, the blame cannot be laid at the door of trade liberalisation. The problem lies more in the inability of the government to collect domestic taxes – both direct and indirect.

Next important issue concerns the role of budget deficit. As noted before, the phenomenon of declining foreign aid has acted as the main constraining force on the fiscal operations of Bangladesh in the last two decades. In response to the loss of resources entailed by declining foreign aid, the government of Bangladesh had the option of reducing public expenditure accordingly, which would have resulted in a sharp reduction in budget deficit. In the event, the government decided not to allow public expenditure to decline, by (partially) replacing the lost foreign resources by mobilising additional domestic resources through increased domestic borrowing (Table VI.1). Elevated budget deficit was thus deliberately used as an instrument of mobilising new domestic resources in the face of declining foreign aid.

Table VI.10
Trends in import Duties as Percent of Imports and GDP: 1991/92-1995/96

	1991/92	1992/93	1993/94	1994/95	1995/96
Percent of Imports^a					
Customs Duties	20.8	18.1	17.8	15.7	13.8
Other Import Duties ^b	9.9	11.0	10.7	10.2	10.4
Total Import Duties	30.7	29.1	28.5	25.9	24.2
Percent of GDP^c					
Customs Duties	2.3	2.3	2.2	2.4	2.3
Other Import Duties	1.1	1.4	1.3	1.6	1.7
Total Import Duties	3.4	3.7	3.5	4.0	4.0

Notes: ^a CIF value of imports. ^b Include VAT and Supplementary Duty on imports. ^c GDP is at market prices.

Source: The estimates of import duties are those of the Revised Budget. Import estimates are from the Bangladesh Bank.

Since even this elevated deficit turned out to be less than what it used to be, as a result of improved revenue collection, the government's decision to replace foreign aid by domestic borrowing did not raise any major concerns for some time. But things have changed considerably in the recent years. Budget deficit has increased from just over 4 per cent of GDP in 1997/98 to around 6 per cent in the following three years. This has raised serious concerns in certain quarters. For instance, a recently concluded Public Expenditure Review of the World Bank has made dire predictions about the consequences of such heightened deficits (World Bank 2002b). If their advice for a sharp reduction in deficit is to be heeded, the result will be a demand deflation in the short term, because given the institutional bottlenecks that exist in the way of raising additional revenue, the only way to reduce deficit in the short term is to cut expenditures. If the consequences of the deficit are indeed dire, then of course one may have to accept a temporary contraction as the price of long-term benefits. However, if the consequences are unduly exaggerated, this will lead to an unnecessary contraction of aggregate demand that may jeopardise the process of demand-driven growth that has boosted the Bangladesh economy in the last decade. Therefore, before the counsel for contraction is

heeded, it is essential to get a clear idea of the nature of increased deficit and its consequences.

World Bank, in its Public Expenditure Review (World Bank 2002b), has made a number of arguments in support of its concern: (a) the current level of deficit is fiscally unsustainable, (b) by crowding out private investment it will reduce growth and thereby hamper poverty reduction, and (c) it is leading to external sector dis-equilibrium in the shape of heightened current account deficit. Each of these arguments is seriously contestable.

The argument about fiscal un-sustainability is based on a number of precarious assumptions, one of which is that higher budgetary expenditure will not have any positive effect on economic growth⁴². The same study recognises, however, that the major reason behind higher deficit is higher capital expenditure by the government (Schmidt-Hebbel 2001, p.7), which makes the assumption of no feedback on growth clearly untenable.

The second argument is in the nature of a half-truth. It is true that according to the econometric estimates produced by the study, public expenditure crowds out private investment. But according to the same estimates, the crowding out is only partial. So, if the deficit is being driven mainly by higher public investment, there should be no negative effect on growth and hence no adverse effect on poverty.

The argument about budget deficit leading to current account deficit is equally untenable. While it is true that both internal and external deficits have increased at the same time, there is no obvious causal mechanism linking the two. Crucially, the rate of inflation has fallen during the same period, which does not indicate the existence of any excess demand resulting from fiscal expansion and spilling over into the external sector. A plausible alternative explanation lies in the observed surge in private investment, which, because of its import-intensive nature, has led to foreign exchange crisis in the manner envisaged by the long-forgotten two-gap models.

These counter-arguments are not meant to promote complacency about fiscal deficits, but to warn against knee-jerk reactions at the first sight of a rise in deficit, as this may cause more harm than good by unnecessarily depressing aggregate demand. Since aggregate demand played a key role in promoting pro-poor growth in the last decade (as argued in section IV), such an outcome would be especially unfortunate.

The point remains, however, that policymakers must remain alert to any possibility of reducing deficits in a manner that avoids harmful effects on the economy. This will call for taking a number of steps in the medium to long term – e.g., improving the institutional and administrative apparatus for revenue collection, reducing wasteful expenditures, and bringing down the real rate of interest so that any given level of deficit can be made more sustainable. One aspect of the issue of wasteful expenditure involves the question of how to deal with the burgeoning losses of SOEs that are putting an increasing strain on the public exchequer. This is part of the broader issue of privatisation, which has been dealt with in the next section. The issues related to the real rate of interest are discussed in the context of financial policy in section IX.

⁴² The detailed methodology of assessing sustainability is spelt out in Schmidt-Hebbel (2001), one of the background papers of the World Bank's Public Expenditure Review.

VII. PRIVATISATION AND RELATED POLICIES TOWARD STATE-OWNED ENTERPRISES

VII.1. An Overview

The history of SOEs in Bangladesh is somewhat different from that of middle-income economies like Egypt, Turkey, Brazil, and even from its low-income neighbours like India. The countries in the latter group had a much longer and relatively successful history of state-initiated development during which a substantial productive capacity was created. In fact, the most pronounced manifestation of the problems of SOEs in these countries took place in the 1970s with the culmination of the adverse effects of the oil crisis, global recession and rising indebtedness. It was in those years of international economic turmoil that the state in Bangladesh became the *de facto* owner of a large number of enterprises after independence. Therefore, privatisation in one form or another seems to have been on the agenda throughout. In fact, the very first privatisation in the form of denationalisation of abandoned enterprises started as early as 1975 and continued in varying speed into the 1980s when a second wave of divestment was initiated under the military government of General Ershad⁴³.

Both in the past and at present the predominant method of privatisation has been divestiture – mostly “sale through tender“ of shares or the whole entity, although the Privatisation Policy of 2001 allows for other forms of privatisation such as sale through capital market, management contracts, leasing, and liquidation. Almost all divestitures comprised industrial units, especially jute and textile mills, except for two public banks which were also denationalised in the 1980s.

Privatisation in the 1980s had been most extensive and outstandingly rapid in comparison to the process in the 1990s. The share of the public sector in total industrial assets was more than halved during 1982 to 1986 through the transfer of public industrial and commercial enterprises to the private sector. The pace of this process significantly slowed down in the late 1980s and during the 1990s. Between 1988 and 1999, only 29 enterprises were divested either wholesale or partially as opposed to more than 650 enterprises divested/denationalised during 1982-1986.⁴⁴ Various sources attributed this slowness to a number of factors such as lack of consensus, political commitment and investor interest (Islam 1999; World Bank 2002c). The poor performance of the divested enterprises after privatisation as revealed by a number of surveys in the 1990s may also have played a role in weakening the already fragile accord on the benefits of privatisation in Bangladesh.

The characteristics of the privatisation process in Bangladesh in a comparative perspective are revealed to some extent by the data in Table VII.1. First, Bangladesh is one of the few countries that attracted no foreign direct investment (FDI) to the divested enterprises up to 1995. Secondly, revenue generation was strikingly low. The primary reason for this is that the privatisation process in Bangladesh has been more or less confined to the relatively smaller labour-intensive industrial units operating under more competitive market conditions such as textile and jute mills. In general, revenue generation through divestment of SOEs with natural monopoly characteristics (e.g. as in utilities) is known to be much larger; and this has been absent in Bangladesh.

⁴³ See Humphrey (1990) for an overview of privatization in Bangladesh in the 1970s and 1980s.

⁴⁴ The share of public sector declined from 85 per cent in 1982 to 40 percent in 1986 (Bhaskar and Khan 1995).

Table VII.1
Privatisation in a Number of Low Income Economies (1988-1995)

	Revenues (US\$ Millions)	Number of Privatizations	FDI from Privatisation (US\$ Millions)	Average Revenue per divested firm (US\$ Millions)
Bangladesh	60	27	0	2.2
Benin	54	12	44	4.5
Burundi	4	8	0	0.5
Côte d'Ivoire	154	24	26	6.4
Ghana	619	52	451	11.9
India	5,205	62	85	84.0
Indonesia	4,014	15	1,617	267.6
Laos	32	25	18	1.3
Nepal	13	8	1	1.6
Pakistan	1,576	92	928	17.1
Sri Lanka	288	57	95	5.1
Uganda	101	34	64	3.0
Zambia	71	10	52	7.1
Zimbabwe	307	3	246	102.3
Total	131,048	3,793	47,456	34.5

Source: World Bank (2000) Development Economics Prospects Group

On the other hand, the sluggish progress in the late 1980s and in the 1990s has been accompanied by two developments – a major change in the entry barriers and a considerable downsizing in the public sector. A wide range of sectors that were previously in the sole domain of the public sector – including infrastructure, power distribution, telecommunications, natural gas exploration – have been opened to private sector participation. Nevertheless, private sector has not been forthcoming except for some investment in power generation, natural gas exploration and water. While divestment has been meagre in the last decade, the governments' commitment to withdraw public sector from real productive activities, especially from the manufacturing sector, has been maintained by ceasing its expansion in the industry.

Privatisation Policy of 2001 outlines main objectives of privatisation in Bangladesh as follows:

- a) Increasing social welfare through efficiency gains.
- b) Attracting foreign investment.
- c) Receipt of revenue through divestment.
- d) Release of the revenues from loss making enterprises for other social needs.
- e) Protecting and promoting employment opportunities by promoting competitiveness.

However, there is limited information and knowledge about various dimensions of social impact of previous. Although all of the main objectives given above are related to revenue generation and its use for social purposes, the data on divestment revenues and how they are used is rather patchy and in many cases absent. Official estimates of divestment revenues for the last two decades show that gross revenue generation has been rather dismal throughout the period. In most years, gross revenue generated was well below one per cent of total government expenditure. Only in a few of years did the proportion rise above one per cent – e.g. 1.5 per cent in 1983 and 1.1 per cent in 1993⁴⁵.

⁴⁵A major reason for low sale prices lies in the endemic indebtedness of the SOEs. Since the private investor is required to take on the debt liabilities of a SOE once it is privatised, the sale price of the enterprise is marked down as an adjustment for this transfer of liabilities. In practice, however, most private buyers tend to default on inherited loans. As a result, the

Although gross divestment figures, such as those quoted above can be useful indicators, what is more important is the amount of net revenue generation after deducting administrative and restructuring costs (e.g. long term and current debts of SOEs, compensation offered for the separation of redundant employees, and so on). Of these, the compensation package for the retrenched employees is likely to be the largest in the case of Bangladesh for the divestments planned for the future. Long-term liabilities, though transferred to buyer, are deducted from total sale price and cause a substantial reduction in sale price. For enterprises to be divested in 2002-2003, reduction in expected sale price due to indebtedness of these enterprises varies between 43 and 67 per cent, with average reduction being 38 per cent. A further concession is granted to investors purchasing privatized enterprises by providing them with a long-term debt to pay off current debts. In addition to these, they are entitled to a maximum rebate of 40 per cent from sale price provided they pay all dues within 30 days in foreign exchange. When all these concessions are taken into account, it is reasonable to conclude that the net revenue contribution of the sales proceeds of privatisation has been and will continue to be negligible in Bangladesh. Therefore, even if it was assumed that the entire net revenue would be spent for pro-poor expenditure, the absolute impact on poverty reduction would be insignificant.

However, in addition to direct revenue windfall from sale of SOEs, there is an indirect revenue implication as well - revenues that are saved on a recurrent basis by getting rid of loss-making SOEs. The magnitude of this revenue impact is in fact quite large in Bangladesh and can have significant implications for financing pro-poor activities, as following analysis shows.

VII.2 Financial Performance of SOEs

The primary rationale for reforms of the SOEs in general, and for privatisation in particular, lies in their weak financial performance. The same is true for Bangladesh. The SOEs in a number of developing countries contributed just over 10 per cent of GDP and claimed a little over 20 per cent of gross domestic investment (GDI) in the 1990s. By contrast, the SOEs in Bangladesh have claimed on average 8.3 per cent of GDI but contributed less than 1.8 per cent of GDP since the early nineties. Even though differences in the structure of SOEs and capital intensities of investment render such inter-country comparison difficult, these figures would suggest that the efficiency of resource use and growth performance of SOEs vis-à-vis their investment has been poor in Bangladesh by international standards.

All indicators suggest that the financial performance of SOEs has deteriorated noticeably in recent years. For example, their contribution to GDP, which averaged about 2 per cent of GDP over mid-1990s, has declined to less than 1 per cent in recent years. As a proportion of operating revenues, their value-added has come down from around 25 per cent in the early nineties to about 10 per cent in recent years. The major SOEs in manufacturing and utilities contributed a mere 0.8 per cent to the absolute increase in GDP in constant producer prices during 1990s. This poor contribution is explained by a combination of problems, which include low productivity, inefficient input use, high system loss and unfavourable trends in output prices relative to input prices.

The efficiency of resource use by SOEs – as reflected by their pre-interest rate return on assets (ROA) has averaged just 0.1 per cent during the 1990s. As against this, the prevailing rate of interest charged by most commercial banks on working capital and term loans has

banking system, which used to suffer from non-repayment of loans by the SOEs, continues to carry the burden of non-performing loans even after privatisation.

varied between 13 to 16 per cent. This means that the returns on SOEs' investment has been inadequate, by a very long way, even to meet the prevailing cost of funds, let alone to generate a true surplus to finance debt amortisation or capacity expansion. Only generous subsidy from the government has kept most of them going.

Actual subsidy provided by government to SOEs is much larger than budgetary subsidy to SOEs, which is defined narrowly in government budget to include only direct subsidies to a few entities. This does not reflect the bulk of budgetary resource transfers, which take the form of both direct financing of SOEs' budget deficit and many indirect and hidden transfers. Direct budgetary financing of the SOE deficit has been provided through the following forms: direct subsidies and grants, loans, equity, and capital restructuring (conversion of loans into equity or grants). The major category of SOE expenditure financed directly through government budget is their investment programme supported under the ADP. Other forms of support through the budget include financing of wages, direct subsidies to some to a few SOEs, working capital loans for purchase of raw materials and manpower separation payments (retrenchment benefits), and capital restructuring through infusion of new equity.

The inability of SOEs to generate internal surplus has resulted in large budget deficits. Defining the SOEs' budget deficit in a manner analogous to that of central government's budget deficit – to reflect the financing gap between total expenditure and total earnings – it is found that gross SOE deficit has increased from less than 2 per cent of GDP in the second half of the 1990s to an average of 2.6 per cent during 1999/00-2001/02 (Table VII.1).⁴⁶ Out of the SOE deficit of 2.6 per cent of GDP in 2000/01, financing of SOEs' investment under ADP was 2.0 per cent of GDP. Together with other items of expenditure, budgetary financing of SOE deficit has been estimated at around 2.2 per cent of GDP in that year (World Bank 2002c). This implies that by far the major part of SOE deficit is financed directly by the government budget.

Much of the resource transfer from government to SOEs has, however, been effected through indirect means. These include: (a) default of SOEs on debt service liability and tax and dividend payment to government, (b) recapitalisation of banks on account of default by SOEs on debt servicing on bank loans, (c) subsidised loans and equity, and (d) subsidised inputs.

The financial losses of SOEs thus account for a significant part of the strain on government budget. The recent increase in budget deficit has been associated with a corresponding increase in SOE deficit. By serving to raise the overall budget deficit of the government, SOE losses are thus creating pressure to cut down expenditure on other sectors so as to keep the overall deficit under control. These losses, therefore, involve a significant opportunity cost in terms of foregone spending on other sectors.

In the context of the impact on poverty, a measure of such opportunity cost can be obtained by viewing SOE losses against public spending on social sectors. During the period 1991/92-2001/02, gross losses of SOEs (defined as total losses of all loss-making enterprises) were on the average equivalent to 30 per cent of annual budgetary spending on health and education and this proportion is increasing. In the year 2000/01, for example, gross losses of the SOEs were equivalent to 38 per cent of the spending on education and health under recurrent and capital budgets combined. This is not to suggest that any savings of resources made by

⁴⁶Gross SOE deficit = retained income (net profit/loss – dividends) + depreciation – capital expenditures – loan amortisation.

improving the financial performance of SOEs will automatically be redirected towards pro-poor channels. But at least the potential for such redirection will improve.

Another measure of opportunity cost can be found by looking within SOE sector itself. Detailed analysis of SOEs reveals that recent deterioration in their financial performance is due to both a sharp decline in their internal savings and a sizeable increase in their investments (World Bank 2002c). The savings decline has resulted from poor operational performance, partly due to unrealistic pricing policies, particularly in gas, petroleum, power and fertilizer. Investment expansion took place mostly in power, water resources, oil, gas and mineral resources and transport. These are all potentially useful investments for improving infrastructure, which is essential for ensuring sustained growth. However, mounting losses of SOEs will eventually call for a brake on such investments, thereby compromising potential for growth and poverty reduction.

The attempt to minimise the SOE losses should, therefore, form an important part of any macroeconomic policy reform. This goal can in principle be achieved through many alternative means and privatisation is only one of them. In practice, however, not much success has been achieved through other means that attempted to improve the performance of enterprises while retaining them within public sector. Weak governance and the problem of soft budget constraint have pre-empted possibility of success. This has made the case for privatisation more pressing than ever.

There are, however, a number of other issues that one needs to consider before suggesting privatisation as the solution to the problem of SOEs. One sceptical view of privatisation argues that this option does not necessarily lead to greater efficiency, especially if underlying cause of losses lie in exogenous factors, such as adverse demand conditions, higher input prices, etc.

This line of argument draws upon a few studies that looked into performance of SOEs after they were privatised. For example, a survey conducted by the Board of Investment in 1991 revealed that 53 per cent of privatised companies were either shut down or dysfunctional. Those that were still operational were not performing in a superior way in any sense⁴⁷. A second study carried out by Sobhan and Mahmood (1991) compared the performance of denationalised jute and textile mills during 1981-85 (in terms of output growth, volume and quantity based factor productivities, wastage, etc.) with those that was publicly owned. The findings of this study indicated that production in the privatised jute mills had declined since denationalisation. Machine productivity and wastage has been notably poorer in the denationalised mills. The overall evidence in this study does not point to increased efficiency and profitability after privatisation. Finally, the findings of Sen's (1997) survey covering 205 firms privatised during 1980s and 1990s found the closure rate to be around 40 per cent⁴⁸. On the other hand, the profitability of the enterprises still in operation was found to have increased after privatisation.

There is thus no unambiguous evidence that privatised enterprises are more efficient than SOEs in Bangladesh. High closure rates after privatisation and lack of a strong evidence of improvement in terms of efficiency suggest that there are certain structural features of

⁴⁷Reported in Sobhan (1991, p. 206).

⁴⁸Akram (2000) has suggested that Sen's survey would indicate a 28 per cent closure/exit rate if the term 'closure' is modified to take into account different forms of closure (e.g. liquidation, inactivity). In any case, the closure rate is much more than marginal.

Bangladesh economy that inhibit viability of privatised enterprises with certain characteristics (e.g. old technology, indebtedness, facing persistent declining demand) as much as the public enterprises in the same sectors.

It would be a mistake, however, to conclude from this evidence that privatisation did not lead to any efficiency gains. When privatised firms manage to improve efficiency, as found in Sen's (1997) sample, this clearly indicates efficiency gains. If they remain inefficient even after privatisation, as several other studies have shown, they will have to go out of business (unless of course the government props them up through artificial means). And inefficient firms going out of business is part of the process of gaining overall efficiency. So, either way, efficiency improves. Therefore, the evidence that many privatised firms are just as bad as SOEs and do not survive for long cannot be cited as a reason for rejecting privatisation on efficiency grounds.

In fact, it is very difficult to resist privatisation on efficiency grounds unless one can invoke the existence of hard-to-remedy market failures – of the kind that will prevent the private sector from taking up an enterprise despite its high social value. This argument is difficult to sustain in the context of Bangladesh, however, where privatisation is being contemplated mainly for SOEs that are involved in manufacturing sector producing private goods as distinct from public goods.

There are, however, other arguments against privatisation that focus on equity rather than efficiency. Two such arguments are worth considering in some details – one focuses on labour retrenchment following privatisation and other on quasi-fiscal role of many SOEs.

VII.3. The Equity Aspect

Privatisation is often accompanied by large-scale cuts in employment. This is indeed the main reason why many opponents of market-oriented reform resist privatisation. The process of privatisation in Bangladesh has also been characterised by substantial labour retrenchments. In addition, the non-privatised SOEs have also adopted a labour retrenchment policy under a voluntary separation scheme (VSS).

Workforce retrenchment in SOEs was initiated in early 1990s, mostly in manufacturing, but the process has slowed down noticeably in recent years. About 120,000 SOE employees have departed so far since early nineties. Net downsizing has, however, amounted to 70,000 workers in the last decade, implying that some 50,000 workers were recruited by SOEs in the same period. Total SOE employment has declined from 0.3 million in the early nineties to 0.23 million at present. There is no doubt that any cut in employment causes immediate distress to those directly affected by it. But a dispassionate assessment of the impact on poverty must take into account a number of considerations.

First, in so far as overstaffing has become an endemic problem of the SOEs, retrenchment of labour has to happen sooner or later. Privatisation often offers the occasion to make this happen, but the blame lies not with privatisation *per se* but with the overstaffing that had occurred beforehand.

Second, it is not at all clear that the majority of workers laid off belong to the category of the poor. A recent study shows that more than half of all the retrenched workforce fell into the skilled labour force category with about one third being considered as semi-skilled; unskilled

workers constituted only about 14 per cent of the total (ILO 1999). It is only the last category that will unambiguously count as poor.

Third, the transitional pain of labour retrenchment can be considerably eased through various means, including the kind of monetary compensation that has been practised in Bangladesh⁴⁹.

As regards to quasi-fiscal role of SOEs, the point is that the pricing policies of many SOEs offer implicit subsidies to various population groups, and to the extent that the poor receive a share of those subsidies privatisation will be anti-poor because privatised firms will no longer permit subsidy. A basic theoretical problem with this argument is that if the intention is to provide subsidy to the poor, in most instances doing so through price manipulation will not be the most efficient strategy.⁵⁰

Besides, the reality in Bangladesh is that in the majority of cases subsidies offered by SOEs do not actually have a pro-poor bias. In general, the pricing policy of SOEs cannot be described as pro-poor. As a recent World Bank study notes:

- Access to power is limited to slightly over 30 per cent of population, mostly urban. Rural consumers, who are generally poorer, have paid a higher price than urban consumers.
- As in the case of power, gas subsidies benefit only a small minority of urban residents.
- Tele-density of fixed telephone lines is just 0.4 per hundred people, one of the lowest in the world, and together with high telephone charges this has deprived the poor of cost effective communications services.
- Sugarcane farmers and *gur* producers as well as consumers, largely the rural poor, have been taxed in order to sustain sugar production.

Thus neither on efficiency nor on equity ground can one make a strong case against privatising perennially loss-making SOEs. On the contrary, in view of the fact that budgetary burden of these losses inhibits increased allocation to social sectors, one may even argue that privatisation can be rendered compatible with a pro-poor macroeconomic policy in Bangladesh by ensuring that resources saved through privatisation are actually utilised for pro-poor expenditure and that adequate compensation is paid to the poor retrenched workers.

Of course, the modalities of privatisation also matter. There are both good ways and bad ways of doing it, and some of the bad ways may actually do more harm than good. But that's a different problem altogether.

⁴⁹There is one practical problem with the compensation policy, however. Because the proceeds from selling off the SOEs have been very meagre, much of the resources for compensation had to be obtained by borrowing from the state-owned banks, most of which were themselves in dire straits. To that extent, the privatisation process has merely transferred some of the liabilities of the manufacturing enterprises to the financial SOEs. This has not only reduced privatisation's ability to restore the financial health of the public sector as a whole, but has also complicated the process of financial reform.

⁵⁰In theory, some amount of agricultural input subsidy can be justified on both efficiency and equity grounds, if there are sub-optimal levels of fertiliser use, particularly by poorer farmers exposed to an imperfect credit market. In this situation, a case for subsidy withdrawal rests on the argument that the money thus saved may be better used for rural infrastructure that could help farmers reap higher yields and get better product prices. But this leads to the more complicated behavioural question about the government's 'marginal' expenditure propensities (and the resulting marginal social value of such expenditures). See Osmani (1985), Osmani and Quasem (1990) and Rahman and Mahmud (1988) for arguments along these lines.

VIII. EXTERNAL SECTOR POLICIES

Bangladesh has pursued an increasingly liberalised policy towards the external sector over the last two decades. The policy reforms have included widespread trade liberalisation as well as a market-oriented exchange rate policy.

VIII.1 Trade Liberalisation

Trade liberalisation effort started in the mid-1980s and already by the end of the decade Bangladesh had moved from the initial phase of removal of quota restrictions to that of tariff reductions. In the initial stage, substantial trade liberalisation occurred mainly in agriculture, liberalisation of industry came somewhat later. In the mid-1980s, agricultural liberalisation took the form of removing non-tariff barriers on import of irrigation equipment. The most important non-tariff barrier consisted of restricting imports to limited range of STW engines, which were also relatively costly. Once this restriction was lifted, the market was flooded with a wide variety of cheaper engines that spurred a sharp increase in irrigated acreage, leading to a discrete jump in rice production in the late 1980s (Ahmed 2001). The salutary effect this has had on poverty in the 1990s are discussed in Sections III and IV of this report.

A second wave of agricultural liberalisation came in 1990s when state monopoly on the import of rice was ended and private traders were allowed to enter the business. By that time, the production of rice had reached a level that was sufficient to meet domestic demand at stable prices in normal years. It was only in the years of especially bad harvest that the need could arise for importing large quantities of rice. And when the need did arise following the devastating floods of 1998, the liberalisation of rice trade proved to be a great boon. Private traders promptly responded to the crisis by importing huge quantities of rice from India and the prices soon stabilised, as the import parity price of Indian rice acted as a ceiling on the price of domestic rice. Much hardship of the poor was avoided as a result.⁵¹

The liberalisation of industrial products began in the late 1980s with the removal of import controls, which resulted in the elimination of the very high 'implicit' tariffs (that is the scarcity premia) that had characterized earlier trade regime⁵². New rounds of trade reforms were undertaken in the early 1990s. The objective was to achieve further import liberalization by reducing import tariffs to significantly lower and more uniform levels⁵³. The impact of these reforms on the average rate of import tax and on the average rate of nominal protection can be seen from the estimates in Table VIII.1, which show both the un-weighted average and the import-weighted average of import-item-specific rates. The nominal rate of protection is estimated by excluding the import duties that have no protective effect, such as VAT introduced in 1991/92. VAT is imposed on all types of imports (with some exemptions) and on domestic production under its coverage; the assessment of tax on the later is adjusted for the VAT paid on intermediate goods, imported or otherwise.

Starting from the withdrawal of quota restrictions in the late 1980s to tariff reductions in the first half of 1990s, Bangladesh has had one of the most rapid episode of import liberalization compared to other countries during their similar period trade reforms (the third most rapid liberalization episode among the 34 countries in Oxfam 2002, p.132, Figure 5.3). Yet at the

⁵¹Dorosh and Shahabuddin (1999) and Dorosh (2001) present convincing evidence for this contention.

⁵²For the estimated trends in 'implicit tariffs', see Rahman (1994).

⁵³For detailed discussion of the nature of trade and industry reforms and their impact, World Bank (1992, 1994, 1999a, 1999b), and Yilmaz and Varma (1994).

end of this period, Bangladesh still remained relatively "closed" in terms of the extent or depth of liberalization (though ahead of many countries including India, Pakistan, Vietnam, Thailand, and China). Thailand, Indonesia and Korea not only had much slower liberalization, but also they remained much more closed at the end of their initial period of import liberalization in the mid-1980s compared to Bangladesh in the mid-1990s. Further liberalisation since then in Bangladesh has been rather slow.

The extent and the speed of further import liberalization remain a contentious issue in the economic reform agenda of the government. Is further liberalization the way forward, and if so, at what speed? Even if the critics are right in arguing that liberalization was too rapid, a general reversal is not on the agenda, since the country is still relatively less "open" compared to many developing countries. However, one could still discuss any adverse effects for learning lesson for future. This is particularly true in analysing patterns of liberalization and its sector-specific impact. The standard practice is to look at changes in aggregate figures of import tariffs (protective and total, simple or import-weighted average) and in the dispersion of the tariff rates. Very different outcomes, with important varying implications for poverty, may happen depending on structure of tariff reforms hidden in these aggregate figures. Thus, quite apart from contentious issues relating to speed and depth of import liberalization as measured by these aggregate indicators, the 'industrial policy' implicit in these reforms needs scrutiny from the point of view of pro-poor growth.

Table VIII.1
Trends in Average Duty Rates on Imports, 1990-91 to 1999-2000

	1990-91	1991-92	1995-96	1999-2000
All Tradables				
Unweighted mean	89	67	27	25
Import-weighted mean	42	29	22	20
Manufactures				
Unweighted mean	89	68	27	25
Import-weighted mean	52	27	24	24

Note: Estimates includes all taxes, fees and surcharge on imports.

Source: World Bank (1999a).

Clearly, an active industrial policy has a key role to play more so in the transitional reform period, as the impact of such reforms is bound to vary considerably across industries and sectors. If there is no well-devised industrial policy, there will be one by default. This is all the more so because tariff reforms have to cope with many structural limitations of the existing tax system that often give rise to policy conflicts between efficiency, equity and revenue objectives of taxation. For example, the taxation of imported intermediate (as well as capital goods), which is undesirable on grounds of production efficiency, is an important source of revenue and is often the only means of taxing a large part of domestic production. There is thus a need for removing discrimination against exports, often by selective intervention. The existing schemes of duty-drawback, bonded warehouses and selective cash incentives for exports are essentially means for providing exporters access to duty-free imports of production inputs (or for compensating for payment of such duties). The selectivity of such intervention depends not only on economic criteria, but also, of necessity, on their administrative feasibility and effectiveness. There is a valid concern therefore about how far the sectors that contribute relatively more to poverty alleviation have fared in this reform process.

The policy of combining import liberalization with flexible exchange rate management is mainly concerned with achieving allocative efficiency by reducing excessive protection to domestic industries and removing the adverse incentive for export. The effects on the relative incentive structure between large-scale organized and small-scale informal sectors arise mostly as a by-product. Nevertheless, the available evidence shows that small-scale manufacturing activities (excluding the handloom and cottage industries) have fared better than large-scale manufacturing in the post-liberalization period. According to national income statistics, the former is estimated to have grown at 9.2 percent annually between 1991/92 and 1999/00 while the latter at 7 percent (and at only 4.3 percent excluding RMG⁵⁴). During the same period, value added from cottage industries grew at 2.8 percent annually and that from handlooms at 2.8 percent. Small industries seem to have benefited from liberalisation of import of capital machinery and raw materials (Bakht 2001). Their products being mostly remote substitutes of imported items, they may have also expanded at the cost their large-scale counterpart facing stiffer competition from imports⁵⁵. Trade liberalisation may thus have played an important role in promoting the growth-poverty nexus described in section IV, whereby accelerated growth of small and medium scale enterprises helped reduce poverty by absorbing surplus labour into more remunerative salaried employment.

This does not mean that there was no scope for providing even better support to the growth of small and informal sector activities by adopting a pro-active and analytical policy regime. A few examples will suffice. Because of the end-use discrimination of import tariffs, imports of capital goods (along with primary commodities) are subject to much lower rates of tariffs compared to intermediate goods and finished consumer goods⁵⁶. In this respect, there are certain anomalies that discriminate against informal sector. For example, compared to machinery and industrial inputs used in large-scale manufacturing, items like sewing machine and small hand tools are taxed highly, perhaps because of their part use as consumer items.

A more important effect of the tariff reforms has been to stifle the growth of domestic engineering and capital goods industry⁵⁷. This adverse effect of import liberalisation has been discounted because of the rather small size of this industry and because the removal of duties on machinery imports has been a means of providing incentives for other industries. This ignores potential role of a domestic capital goods industry in technological adaptation, which is especially important for upgrading traditional technology in informal sector and for facilitating sub-contracting arrangements with large-scale firms. This may be one reason why sub-contracting arrangements have not developed in Bangladesh as in many other developing countries. Large-scale industries in Bangladesh, on the other hand, rely almost entirely on imported machinery⁵⁸.

Because of its very limited access to export market, the informal sector has not much to gain from the real devaluation of exchange rate that has accompanied import liberalisation. The exports of informal sector cannot also feasibly take advantage of duty-free access to imported

⁵⁴Estimated as compound growth rates of value added between two years; cf. Statistical Yearbook of Bangladesh 2000, p.452.

⁵⁵This may not be the entire story. Small-scale industries are likely to have grown at the cost of cottage industries.

⁵⁶Between 1992 and 1996, the import-weighted average custom duty rate on capital goods declined from 19 percent to 10 percent, and for final consumer goods, from 47 percent to 21 percent; see World Bank (2000), p. 39.

⁵⁷A striking example is provided by the decline of domestic textile machinery industry (power looms); this industry has been virtually eliminated during past 7-8 years.

⁵⁸In the budget for 2002-03, cash incentives have been provided to export of light engineering products. After having industry severely squeezed in domestic market, export support measures are unlikely to be successful, at least in near future.

inputs as administered through the system of duty-drawback and bonded warehouses. Only handloom cloth, along with cloth in general, was given a cash subsidy on export, including indirect export in the form of sales to export-oriented garment industry (at quite a high rate of 25 percent of gross value of production, which will be now phased out by 2004 to reduce the budgetary burden). Thus, except for handloom clothes, the direct and indirect exports of the informal sector have generally suffered discrimination. In recent years, the facility of cash subsidy on export (at 5 to 10 percent) has been extended to cover some other items, including some produced in the small-scale and informal sector, such as processed food, cut flowers and light engineering goods.

It is true that most of the informal sector is outside the tax net so that they are taxed only through taxes on their inputs. Small-scale enterprises with a minimum annual turnover are required to pay a turnover tax instead of VAT, but this tax is also mostly evaded. This tax advantage of small-scale and informal sector activities should be weighed against their many disadvantages such as lack of access to institutional sources of credit and greater vulnerability to illegal extortion or toll collection that raises their cost of doing business disproportionately relative to larger-scale enterprises⁵⁹.

The case of sericulture, which is an important source of livelihood for the poor in certain north-western regions of the country, provide an example of how trade policies can be effectively combined with other interventions for the benefit of pro-poor growth. While both sericulture (growing cocoon on mulberry plants) and weaving of silk cloth are relatively efficient activities, their competitive edge is eroded by existing inefficient spinning technology. There is thus a dilemma whether to reduce import tariffs on imported silk yarn to promote the production of silk cloth (in which case domestic sericulture will lose out), or to protect spinning, thus making the entire chain of the industry rather inefficient. To solve this problem, some NGOs have taken the initiative of upgrading the spinning technology, so that the entire industry can become competitive.

VIII.2 The Impact of WTO

One important aspect of trade liberalisation is the consequence of Bangladesh's accession to the World Trade Organisation (WTO). Bangladesh was among the developing nations that became members of WTO quite early in the day, although there is little evidence of any serious debates taking place regarding the pros and cons of membership prior to taking the decision. A good deal of discussion has taken place since joining, however, and these have concentrated mostly on the impacts on RMGs and agriculture.

The aspect of WTO that concerns Bangladesh's industry most is the Agreement on Textiles and Clothing (ATC) that was agreed during the Uruguay Round of trade negotiations⁶⁰. The objective of ATC was to liberalise trade in textiles and clothing by phasing out Multi-Fibre Agreement (MFA) that had served to restrict international trade in textiles since 1974. While restricting the overall flow of imports of cheap textiles from developing to developed world, MFA did allow a number of least developing countries (LDCs) quota-based access to the large North American markets, especially for low value-added products. Bangladesh was one of the beneficiaries of this system; as much as 70 per cent of Bangladesh's garments exports gained access to the large US market through this process. This, along with the privileges granted by the European Union's Generalised System of Preferences (GSP), played an

⁵⁹ These findings are based on survey results obtained by Rashid (2000).

⁶⁰ For detailed discussion of these issues, see CPD (2000) and Dowlah (1999).

important part in the rapid expansion of Bangladesh's RMGs industry in the 1990s. The phasing out of MFA by 2005, leading to a completely liberalised environment for trade in textiles, would thus entail the lifting of an international protective umbrella that had served Bangladesh well.

Bangladesh has so far enjoyed the advantage of lower wages compared to other poor countries in Asia, but this is neutralised to some extent by lower productivity of labour. Nonetheless, on balance, Bangladesh seems to have enjoyed a competitive edge in the international market so far, as evidenced by the fact that it has consistently been able to fill its US quota and even penetrate non-quota segment that involves higher value-added products. But understandably there is much concern in Bangladesh regarding stiff competition it would face from other Asian countries in the post-MFA era. The problem will be compounded by new competition from many African countries that are likely to gain privileged access to the US market under the Trade and Development Act 2000.

In order to be able to compete successfully in the post-MFA era, garments industry of Bangladesh will have to take measures to improve its productivity and diversify into higher value-added products. Indeed, attempts must be made to diversify the export base in general, reducing excessive dependence on garments sector. Changes in these directions have already begun to occur – the export base has widened somewhat in the last decade or so. The downturn in the garments industry brought about by the recent slump in the world economy has further highlighted the importance of diversification and the need for improving productivity. How successfully these structural changes are accomplished will have a significant impact on the poverty front as well, since as discussed earlier the growth of garments industry has played an important role – both directly and indirectly – in alleviating poverty in Bangladesh in the last decade.

As for the effect of WTO on agriculture, two aspects need to be considered. First, the level of support Bangladesh will be able to offer to its agriculture as per WTO rules, and the second, the possible impact of removal of agricultural subsidies in the developed world.

Regarding the level of support that can be given to agriculture, the situation is that, unlike many other countries, Bangladesh already satisfies the WTO rules, even before the deadlines for eliminating excess support come into force⁶¹. The adoption of successive structural adjustment programmes over the last two decades has resulted in rapid elimination of agricultural subsidies. Fertiliser subsidy was restored to some extent in the mid-1990s, but in spite of that the extent of support remained below the levels permitted by WTO for the LDCs. For instance, WTO rules permit the LDCs to offer domestic support under the so-called Amber box up to 10 per cent of the total value of production, whereas in Bangladesh the extent of support has been no more than 1-1.5 per cent in the recent past. And the Green Box measures, for which there are currently no upper limits, constitute only about 3 per cent of the value of production. Clearly, the joining of WTO does not entail any reduction of incentive for Bangladesh agriculture. To that extent, there is no reason to expect any dampening, on account of WTO, of the poverty-reducing effect generated by agriculture in the recent past.

More uncertain is the prospect of gaining from new opportunities to be opened up as a result of possible reduction of agricultural protection in developed world. As the markets open up in developed world, commodities in which Bangladesh could potentially capture a market share

⁶¹ The implications of WTO for Bangladesh agriculture have been discussed extensively by Asaduzzaman (1999, 2001) and Shahabuddin (1999b).

include rice, sugar, vegetable oils, fruits and vegetables. But detailed analysis shows that the level of efficiency achieved by Bangladesh in these products is too low to enjoy a comparative advantage (Shahabuddin 1999b). If this problem can be overcome, however, by increasing efficiency of production and improving the support services in marketing and transport, Bangladesh agriculture should be able to gain from WTO membership, with strong positive implications for poverty reduction.

VIII.3 Exchange Rate Policy

The effect of trade liberalisation needs to be examined along with that of the accompanying flexible exchange rate policy. A remarkable aspect of Bangladesh's experience in this respect is that in spite of substantial trade liberalisation taking place at a time of a marked and steady decline in external deficits, the extent of real devaluation of *taka* was much less compared to many developing countries undergoing similar trade reforms. The available estimates suggest that the extent of real devaluation since the late 1980s to mid 1990s was no more than 12 to 15 percent; the process was reversed in the later half of the 1990s when *taka* actually appreciated compared to beginning of 1990s⁶². The effect of tariff reduction was not generally compensated by indirect protection through real devaluation. Moreover, there was a steady increase in real wage in the organised manufacturing sector throughout this period. Thus the import-substituting industries hitherto enjoying high rates of protection is likely to have been particularly hard hit by import liberalization, unless they could significantly improve their productive efficiency. One rare example seems to be the pharmaceuticals industry, which grew rapidly as an import-substituting industry, eventually even entering the export market.

The trends in real exchange rate have put Bangladesh at a disadvantage in export competition with the other developing countries and in promoting an export market within these countries, especially the neighbouring ones⁶³. In the case of trade with India in particular, Bangladesh's bilateral *real* exchange rate with that country and bilateral trade balance showed some remarkable trends. The real value of Bangladesh *taka* as against Indian rupee is estimated to have appreciated by as much as 25 percent or more between late 1980s and mid-1990s. This, combined with the fact that Bangladesh has gone for a much faster import liberalisation compared to India, has resulted in a dramatic increase in Bangladesh's trade deficit with India. This is reflected in the fact that Bangladesh's exports to India can now pay for a meagre four percent of its imports from that country compared to more than 15 percent a decade ago⁶⁴. However, from the poverty perspective, there has been one benefit arising from these movements in bilateral real exchange rate. As noted earlier, commercial imports of rice from India have served in the recent past to mitigate the potential adverse effects of food price hikes at times of poor rice harvests in Bangladesh. This process has been facilitated by the appreciation of *taka* vis-à-vis the Indian rupee.

Should Bangladesh go for further import liberalization and/or for a more aggressive exchange rate policy, as advocated by many? Both policies potentially involve serious risks. Bangladesh's garment export has been already hit by the post-September 11 global recession

⁶² Bangladesh's experience of exchange rate behaviour had also much to do the rapid growth in RMG export, along with the increasing flows of workers' remittances from abroad and a subdued import demand resulting from low growth in investment and other import-intensive activities; for details, see Mahmud (2001a), p. 46-47.

⁶³ According to one estimate, for example, the extent of real devaluation (as measured by the real effective rate for export) between 1985 and 1993 was 40 percent in Pakistan, 53 percent in India compared to 18 percent in Bangladesh; see Statistical Appendix in ADB (1995).

⁶⁴ In the late 1990s, nearly 40 percent of Bangladesh's global trade deficit was accounted for by the deficit with India. This proportion would be even much higher if the trade deficit in illegal trade were taken into account.

and it will face serious competition after 2004 (when garment export quotas are withdrawn in the US market). Development of new export items will take time, as evidenced from the lack of response to cash incentives provided to certain so-called thrust sectors. Further reduction of protection to domestic industries may thus carry the risk of adversely affecting industrial growth. Since the tariffs on capital goods and raw materials are already low, further import liberalisation may not much help the non-tradable producing sectors including small enterprises as it did during past liberalization.

Aggressive devaluation, as advocated by some proponents of export-led growth, is not also much of an option since the exchange rate is already flexibly managed in view of the current account convertibility of the currency. And judging by the negligible size of the premium in the secondary market, the official exchange rate cannot be far from its equilibrium level. More importantly, most parts of the Bangladesh economy in effect represent non-tradables; these include not only services, but also small-scale manufacturing (because of being poor substitutes for imports) and many agricultural products including rice (since domestic prices of these products lie between export and import parity prices at most times and there is therefore no commercial foreign trade in these products). Devaluation is thus likely to adversely effect large parts of economy by increasing price of imported inputs. In a situation where incentives for private investment are already generally lacking, devaluation is likely to worsen the situation (besides adversely affecting the growth of the above poverty-reducing sectors).

Bangladesh's success in garment export was primarily to do with external market factors (quota entry in the US market) and innovative arrangements like bonded warehouses, although maintaining a flexible exchange rate also helped. The growth of the garment industry also contributed to pro-poor growth since its workers, mostly female, came from poor families. The industry is also highly labour-intensive with a significantly higher share of wage in value-added compared to average of organized manufacturing sector. However, single-item-based export growth remains vulnerable to sudden deterioration in terms of trade or other adverse developments in the world economy. Bangladesh is in fact facing such a situation regarding her garment export in the post-WTO era. Providing only price incentives through devaluation will not be enough for achieving a more diversified export growth, unless it is accompanied by other facilitating factors such as better infrastructure including efficient port facilities, standardization of product quality, technological improvements leading to higher productivity, and an improvement in overall domestic investment climate. Successful integration with global economy requires a kind of strategic planning that should go far beyond mere exchange rate management.

Another problem with external sector management is that investment and manufacturing activities in Bangladesh are extremely import-intensive because of lack of growth of industries producing machinery and intermediate goods. The end-use-based discrimination in import tariffs make incentive system heavily biased in favour of producing finished consumer goods for domestic market. As mentioned earlier (see macroeconomic management) an upturn in domestic manufacturing activities tends to create pressures on balance of payments. Since finished consumer goods account for a small proportion of total imports (less than 10 percent barring years of large food grain deficits), import demand is rather price-inelastic. If growth of garment export falters, the economy will have to adjust to a much lower growth of import. This will require relying on less import-intensive sectors like agriculture and informal non-farm activities to sustain GDP growth. This kind of growth will also be pro-poor, as argued in Section III. This will not be easy, however, since the incentive structure will move

against these sectors in the event of deterioration in the balance of payments and the resulting devaluation of *taka*.

IX. MACRO-FINANCIAL POLICIES

IX.1 The Formal Financial Sector

Bangladesh's financial reforms started in the early 1980s by allowing commercial banks to be set up in the private sector, the number of which has gradually increased; about 30 private sector banks (PCBs), including several foreign banks, now operate side by side with four large nationalised commercial banks (NCBs). The PCBs now account for nearly half of total deposits. The second aspect of the reform was to gradually liberalise interest rates from the early 1990s. At the initial phase, floors were introduced for deposit rates and banks were allowed to fix lending rates freely, but within given bands for certain priority sectors (agriculture, export and cottage industries). Banks were compensated for lending at a lower rate to the priority sectors by the amount the difference between the subsidized rate and the market rate. Later on, floor on deposit rates and subsidies on priority lending was withdrawn; but certain ceilings on lending to priority sector still remain. However, these interest rate ceilings are set high enough so as not to interfere much with the freely determined rates.

The earlier regime was based on the belief that credit can be best allocated by the government's dictates. However, NCBs, along with certain specialised development banks, performed poorly in terms of loan recovery and costs of financial intermediation. The new liberalized system is based on the hypothesis that depositors can get a fair return and credit can be allocated more efficiently through market-determined interest rates. The actual results of financial liberalization were, however, far from those envisaged. One main reason for this was that Bangladesh went for financial liberalisation without providing for adequate regulation and supervision⁶⁵.

The private banks were also infected with widespread culture of loan default plaguing the public sector banks, although the reason for this malaise in the two cases was not the same. The NCBs were burdened with politically influenced loans and loans given to loss-making state enterprises, while private banks suffered from 'insider lending' to the sponsor directors of the banks, some of whom simply plundered away depositors' money⁶⁶. It is only after the central bank could enforce some measure of regulation on the behaviour of the sponsor directors that the loan default rate in some of the private banks (and in PCBs as a whole) started to improve compared to the NCBs. The widespread culture of loan default has resulted in high costs of financial mediation as reflected in the very large spread between the deposit and lending rates of interest (currently as high as about 7%). As a result of liberalization, the interest spread has actually increased rather than decreasing through market competition, while relatively efficient private banks, including foreign ones, reaped excess profits. The resulting high cost of borrowing not only tends to depress private investment, it also makes puts strain on government budget by making it harder to maintain any given level of budget deficit.

A notable example of liberalization without providing for regulation is provided by upheaval in country's stock market that happened in the later part of 1996. Just when foreign portfolio funds were beginning to flow into Bangladesh without any restriction, boosting country's

⁶⁵ Ghafur (1995) and Hassan (1996) provide illuminating analyses of financial reforms in Bangladesh.

⁶⁶ Weakness in legal procedures in recovering loans is also a factor. Nearly one-third of all loans of commercial banks are 'classified' involving repayment defaults; of these, about three-fourths can be said to be 'bad' or 'lost' loans. For some banks in the private sector, the proportion of classified loans goes up to an incredible 50 percent or more. The loan repayment position of specialized banks is even worse.

nascent stock market, the market went through an episode of phenomenal boom and bust that virtually destroyed any prospects of its further growth, at least in the near future⁶⁷. This episode was mainly created by the machinations of some unscrupulous share-traders who took advantage of the laxity in regulation. The main losers were the unsuspecting middle and low-middle income families many of whom put their life long saving in stocks and lost most of it.

Table XI.1 shows how the structure of bank interest rates has been affected by reforms. The mechanisms of interest rate determination, following the market-oriented reforms is yet poorly understood. It has been observed by some authors (Hassan 1996) that the interest rates, particularly the lending rates, are somewhat rigidly determined and their variations in real terms are primarily determined by changes in inflation rate. The interest rates are also found to be rather unresponsive to central bank's market-oriented instruments of intervention, including those affecting banks' liquidity position. The central bank has thus only limited influence on credit and monetary expansion, so that the outcome is more by default than by design. This is a major shortcoming of overall macro-financial management and is a reason why 'prudent' monetary policies as a stabilisation measure may sometime result in overkill.

Table IX.1
Trends in the Structure of Interest Rates (in percent)

	FY 87	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97	FY 98	FY 99
Bank Rate	10.75	10.75	10.75	9.75	9.75	8.5	6.5	5.5	5.5	6.5	7.5	8	7
Lending interest rate	14.7	14.7	14.7	14.8	15.0	15.1	14.4	12.8	12.2	13.4	13.7	14.0	14.2
Deposit interest rate	8.6	8.7	8.9	9.1	9.1	8.1	6.5	5.3	4.9	6.1	6.7	7.0	7.1
Interest spread	6.1	6.0	5.8	5.8	5.9	7.0	7.9	7.4	7.4	7.3	7.0	7.0	7.1
Inflation	13.9	6.4	8.4	3.9	8.3	4.6	2.7	3.3	8.9	6.7	2.5	7.0	8.9
Real Lending Rate	0.8	8.3	6.3	10.9	6.7	10.5	11.7	9.5	3.3	6.7	11.2	7.0	5.3
Real Deposit Rate	-5.3	2.3	0.5	5.2	0.8	3.5	3.8	2.0	-4.0	-0.6	4.2	0.0	-1.8

Note and source: The deposit and lending interest rates are weighted averages as reported in the Bangladesh Bank publications.

How has the allocation of loans by commercial banking system affected by the reforms? The estimates in Table IX.2 shows the trends in the amounts of loans advanced by the commercial banks to certain sectors as a proportion of the share of these sectors in the country's GDP in respective years. The proportionate share of annual bank advances going to agriculture and small and cottage industries can be seen to have significantly declined, while large scale manufacturing has been able to hold its ground. The previously designated priority sectors have thus lost out in the competition. One can of course argue that these proportionate shares of bank advances received by different sectors or their trends over time can hardly be any indicators of efficiency of credit allocation. It is, however, well known that farmers and small entrepreneurs are largely deprived of access to formal sources of credit and, as a result, they resort to borrowing from informal sources at much higher interest rates. The returns from activities for which they seek loans are therefore likely to be higher than those in organised

⁶⁷ The average stock price index increased more than threefold in a matter of 2-3 months during late 1996; since then the price index has precipitously dropped far below the pre-boom level.

sectors having access to formal sources of credit. Any diversion of credit away from these sectors can hardly be taken as an efficient reallocation of credit, let alone contributing to pro-poor growth.

Table IX.2
Ratio of Commercial Banks' Loan Advances as Proportion of Sectoral GDP

Sector	FY 87	FY 88	FY 90	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97	FY 98
Agriculture (crops and animal farming)	0.99	0.93	0.86	0.71	0.91	0.90	0.90	0.89	0.84	0.79	0.67
Large and Medium Scale Industry	3.03	2.67	3.63	3.63	3.24	3.17	3.09	3.15	3.28	3.18	3.34
Small Scale & Cottage Industry	1.00	1.01	0.54	0.61	0.56	0.56	0.68	0.64	0.54	0.60	0.39

Source: Estimated from unpublished data of Bangladesh Bank along with the official new national income series.

This does not mean that the previous system of directed or subsidized credit allocations was efficient (say, in terms of loan repayment) or effective in the sense that the benefit of subsidised credit was reaped by those for whom it was intended (given the prevalence of high transaction costs). What it means is that the reforms towards financial liberalization have had little to do with problem of providing access to credit to those sectors or activities that are most starved of credit.

Nor has liberalisation done much to help so-called ‘**missing middle**’ – medium sized enterprises that are mostly bypassed both by formal credit sector, which tends to concentrate on big clients and by micro-credit programmes, which cater to the very small. A number of innovative programmes have been initiated in recent years for extending micro-credit to small enterprises; still the problem of missing middle is likely to remain. Need for new kinds of institutional innovations, particularly when the ongoing banking reforms are aimed at reducing the number of rural branches of the NCBs. Could these rural branches, instead of being closed, reorganized into local/regional banks mobilizing rural deposits and providing credit to local small-scale enterprises? Could bank-NGO collaboration be helpful? These are some of the unresolved questions whose answers must be found if financial policy is to augment the growth-poverty nexus described in section IV.

IX.2 The Micro-Credit Sector

Bangladesh has achieved impressive success in extending micro-credit facility to the assetless poor households who were earlier considered “non-bankable” under the traditional collateral-based financial practices. Following the pioneering work of Grameen Bank, a large number of NGOs as well as government agencies have now adopted micro-credit model in extending credit support to the poor, especially women. Currently, as many as thirteen Ministries / Divisions of Government of Bangladesh are implementing micro-credit programmes of various sorts. Even the private and public banks of the formal financial sector are entering this area.

There has been a virtual explosion of micro-credit programmes in the 1990s, implemented under various institutional arrangements run by NGOs, CBOs as well as (increasingly) by government organizations (GOs). The average annual disbursement of loans from these

programmes stands at over Taka 5000 crores (about US\$ 0.9 billion), far exceeding the scale of total rural operations of nationalised banks and specialised banking institutions taken together.

The geographical coverage of the programmes has also expanded enormously. Excepting some very remote areas, it is now hard to find any village that has not seen the introduction of micro-credit. The Grameen Bank alone has expanded to 40,000 villages out of a total of roughly 68,000. There are some uncertainties regarding the number of target households covered by the MFI. According to Prof. Yunus, the founder of the Grameen Bank, over 75 per cent of poor families have had access to micro-credit so far; however, others suggest less than half that proportion⁶⁸. Whatever precise number, there is no room for doubting the tremendous pace at which micro-credit has expanded in Bangladesh.

A large number of evaluations have found micro-credit programs to be beneficial to their members. The results are robust as to the method of comparison (before vs. after, project vs. control, modified control group comparisons), the choice of survey year, area and data. While the positive effect of micro-credit on household income is a near universal finding, there is some controversy around the size of the effect – in particular, on the question of whether the effect has been large enough to pull the beneficiaries out of poverty. Grameen Bank's own internal reviews suggest that some 42 per cent of its borrower families have crossed poverty line by 2001, judging by ten indicators (size of loan, amount of savings, housing condition, furniture in the house, provision of warm clothing, education of the children, etc.). By contrast, most independent studies find the economic effects in terms of broad based growth opportunities (as measured by income, expenditure, asset, employment) to have been rather modest. This is explained by the fact that the average size of loan disbursed under micro-credit is rather modest, which limits the possibility of a big push.

The aggregate social effects seem to have been higher than the income or asset generating effects. The empowering effect on women has been especially significant. On the whole, the effects of micro-credit have been poverty reducing both as part of enhanced "voice" and increased income/employment. Micro-credit has not proved a suitable vehicle for all categories of poor, especially the landless labour households who have neither the skill nor the aptitude for entrepreneurship. But within this limitation, micro-credit has no doubt played an important part in reducing poverty of very many people in Bangladesh.

Recognising the importance of micro-credit for poverty reduction, the Government has also set up a special umbrella support institution, *Palli Karma Sahayak Foundation* (PKSF) under the public sector. The role of this institution is to act as a wholesaler of MFI funds – attracting fund from various sources and then on lending it to local level small and medium sized NGOs. Over the years, the share of PKSF in the revolving loan fund of MFIs has increased significantly – from nine per cent in 1996 to 24 per cent in 1999.

With the expansion of the reach of MFIs, a set of second-generation problems has emerged. These include: higher rates of loan default, problems of economic sustainability of MFIs, conflict between objectives of commercial viability and social mission, and so on. Currently, some of the advanced NGOs are experimenting with various innovative ideas listed in responding to some of these emerging challenges. Two types of programmes have emerged in recent years within the MFI market, one to specifically address the problems of the extreme

⁶⁸ See, Yunus (2003) and Ahmed (2003) for contrasting estimates of the coverage of microcredit.

poor (as with the case of PKSf and BRAC's ultra-poor programme), while the other caters to the needs of the 'middle poor' and 'vulnerable non-poor' through micro-enterprise loans.

In the light of the emerging challenges, the Managing Director of PKSf has identified, in a recent paper, six strategic issues confronting the future of micro-finance in Bangladesh that are worth considering (Ahmed 2003).

- (i) *Targeting the poorest versus achieving financial viability:* Most MFIs have failed to find any financially viable way reaching credit to the poorest of the households – the so-called hardcore poor. Perhaps the time has come to recognise that needs of these households must be met by means other than credit.
- (ii) *Widening the target group: new products and new financial technologies:* While the MFIs still have considerable scope to expand horizontally, they must turn their attention to the task of vertical expansion e.g., meeting the needs of mature borrowers who graduate to higher income brackets. Horizontal expansion may call for giving more loans to men, who have been underserved so far relative to women. Vertical expansion would require devising a new and larger range of financial products.
- (iii) *Internal and external governance issues:* Research in Bangladesh and elsewhere show that the success of a MFI depends to a large degree on the quality of leadership. This raises the question of where is the next generation of leaders going to come from?
- (iv) *Service charge:* The rate of interest charged by the MFIs has emerged as a vexed issue. The typical rate of interest is somewhat higher than what prevails in the formal financial sector, but considerably lower than the rates charged by the traditional village moneylenders. Some critics of MFIs have argued that their interest rates are too high for the good of the poor, while the MFIs have responded by saying that high transaction costs justify their rates.
- (v) *Accessing non-donor source of funding:* It is to be expected that donor enthusiasm for micro-finance will diminish over time. In any case, in the long run the MFIs will have to prove their ability to survive without donor support. This will require the MFIs to look for new avenues to fund their activities, such as collecting deposits, tapping formal financial sector, and so on. All this will lead to the commercialisation of micro-finance.
- (vi) *Regulatory framework:* An appropriate regulatory framework will have to be devised so as to promote commercialisation of micro-finance in a manner that combines the assurance of financial prudence with the original social mission of the MFIs.

There are indications that the Government of Bangladesh is alert to at least some of these emerging challenges. The Finance Division has recently constituted a committee headed by the Governor of Bangladesh Bank to examining the possibilities of introducing an effective regulatory framework for the MFIs. A Cabinet sub-committee has also been formed, headed by the Finance Minister, to overview the possible areas of co-ordination so as to strengthen micro-finance activities with a view to ensuring their sustainability. The success of these efforts will determine to a large extent how well the financial sector will be able to serve the poor, and especially the medium and small-scale enterprises that have acted as the driving force behind poverty reduction in the last decade.

X. CONCLUDING OBSERVATIONS

Bangladesh achieved a modest reduction in poverty in the 1990s. *Albeit* modest, this was more of an achievement than what the country experienced in the preceding decade, when poverty declined hardly at all. The decade of the 90s also saw a modest acceleration in the rate of economic growth. The overall experience was thus one of pro-poor growth.

Analysis of the growth process and the nature of the growth-poverty nexus that obtained in the last decade showed that this pro-poor growth was driven mainly by the non-tradable sector. Services and small scale manufacturing, both of which belong to the non-farm non-tradable sector, have contributed most to growth acceleration. And the growth of these sectors has in turn been spurred by demand stimulus originating primarily from yet another non-tradable sector – viz. crop agriculture.

While spurring growth, the boost in demand also helped to scale up the average size of non-farm enterprises, thereby expanding the scope for creating wage employment in the non-farm sector. This is in contrast to what happened in preceding decade, when, in the absence of opportunities for wage employment, most of the incremental labour force in non-farm sector tried to eke out a living in low-productivity self-employed activities. Evidence shows that for the poorer segment of population wage employment in non-farm activities provides higher income than self-employment at the lower end of the productivity scale. As a result, the growth process was more poverty reducing in the 1990s compared to the preceding decade.

In short, one non-tradable sector boosted demand for another, and in the process not only led to overall growth acceleration but also created scope for greater reduction of poverty through expansion of wage employment in non-farm non-tradable sector. This was the primary feature of dynamics of pro-poor growth in Bangladesh in the last decade.

The tradable sector also contributed to process, but to a lesser degree. In terms of annual growth rates, tradable sector, especially some export commodities such as RMG, did experience faster growth than non-tradables in the 1990s. The income generated by this sector also added to the overall demand stimulus given to the non-farm non-tradable sector, and thereby contributed to the dynamics of pro-poor growth described above. But, because of its small size, the tradable sector had a relatively smaller effect on both growth and poverty alleviation compared to the non-tradables.

It must be acknowledged, however, that tradable sector also had an indirect positive effect on dynamics of pro-poor growth. There are two aspects of this effect. First, the demand boost originating from crop agriculture owed itself in a large measure to liberalisation of market for tradable inputs, especially STWs. Secondly, more liberalised import of raw materials helped scaling up process of non-farm enterprises, which was instrumental in expanding poverty-reducing opportunities for wage employment. Thus, overall contribution of the tradable sector towards pro-poor growth would certainly be higher than what a direct accounting would indicate. But the fact remains that its effect operated primarily through the expansion of non-tradable sector, which was the main vehicle for promoting pro-poor growth in the 1990s.

The primary lesson this experience holds for pro-poor macroeconomic policy in Bangladesh is that the incentive structure generated by policy must strike a balance between tradables and non-tradables. Blanket recommendation to give priority to tradables under all circumstances –

a tendency often observed in current orthodoxy in macroeconomic policy – may not be justified.

It is conceivable, however, that over time tradable sector will have to become driving force in Bangladesh. As underemployment in non-tradable sector goes down, multiplier effect of a demand stimulus originating from agriculture will weaken, even assuming that future productivity growth in agriculture will continue to offer stimulus. At that point, the tradable sector will have to take over.

This transition from non-tradable-based to tradable-based pro-poor growth will have to be carefully managed. Macroeconomic policy will have to play a big role here. The salient lessons for pro-poor macroeconomic policies that emerge from analysis presented in this report include the following.

- Unduly conservative attitude towards aggregate demand management must be avoided. While budget deficit and inflation must not be allowed to get out of control, occasional blips in deficits should not be allowed to be an excuse for clamping down with a contractionary policy. Otherwise, the demand-driven pattern of growth that has succeeded in reducing poverty in the last decade will come to a halt, to the detriment of the poor.
- Real exchange rate must be kept close to equilibrium, so as not to discourage exports. However, aggressive devaluation must not be allowed to push REER below equilibrium – not only because it is inimical to static efficiency but more importantly because it will militate against pro-poor growth based on non-tradables.
- Financial sector must be reformed so as to bring real interest rate down. This will help poverty alleviation both directly – through credit availability – and indirectly – through enlarging the margin of sustainable budget deficit, especially in a situation where revenue collection remains weak. Loan default must be tackled head on. At the same time, innovative mechanism must be found to make credit available to the ‘missing middle’.
- While tariff reduction and trade liberalisation has moved in right direction, details of the tariff structure must be determined based on a well thought out industrial policy. Incentive must be provided for small tools manufacturing, in particular, and capital goods sector, in general.
- While appropriate macroeconomic policy can create right kind of incentive structure for generating pro-poor growth, realisation of this potential would depend very much on whether poor are able to avail themselves of opportunities being opened up for more gainful employment. For this to happen, the poor must be equipped with adequate human capital, especially in terms of education and health. Bangladesh has made considerable progress in this regard, but there is still a long way to go. Budgetary spending on social sectors must, therefore, be increased.
- The share of the social sectors in public expenditure has actually increased quite substantially over the last two decades. Yet, in absolute terms social expenditure per person remains one of the lowest in South Asia, due primarily to the fact that overall budgetary resources are severely limited. Since overall availability of resources rather than sectoral allocation is binding constraint on raising level of expenditure on social sectors, every possible means must be explored to raise or save additional resources,

especially in view of declining foreign aid. Politically motivated upsurges in current expenditure must be avoided. Wastage in the use of public resources must be eliminated, and inefficiency of SOEs must be tackled head on, with a range of actions that could also include privatisation as an option.

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