Boosting private investment in Bangladesh

Selim Raihan

The long-term trend in GDP growth rate of Bangladesh shows that Bangladesh has continued to improve its rate of growth steadily over the past 46 years after independence in 1971. Starting from a highly volatile growth rate in the 1970s, the GDP growth rate became higher and much more stable and upward in the 2000s and 2010s. The growth rate expanded significantly since the early 1990s, shooting up to over 5% per annum, but importantly exceeding the 6% mark for a number of years during 2000s, and then crossing the 7% mark in recent years. The average GDP growth rate increased from 3.7% in the 1970s to 6.7% in the 2010s. Bangladesh has been able to increase the average GDP growth rate by one percentage point for each decade since the 1990s. In 2018 the country achieved the highest growth rate of 7.9% in the past four decades. Despite the gradual rise in the investment-GDP ratio over the past three decades, in recent years, the share of private investment in GDP has remained static and the share of public investment in GDP has risen. It is also found that the share of private investment in total investment has fallen whereas the share of public investment in total investment has increased. One very important aspect of the pattern of Bangladesh’s investment regimes in the 1990s and 2000s is that the major contribution to the rise in investment-GDP ratio came from the rise in private investment and its share in total investment. Especially, during 1995 and 2008, there was a persistent rise in the private investment GDP ratio. During 2009 and 2017, this ratio fluctuated. Between 2009 and 2017, the ratio of private investment to GDP increased by only 1.2 percentage points.

Bangladesh aspires to achieve 9% real GDP growth rate by 2030. In this case, the required investment-GDP ratio would be around 40 percent under the assumption of a 4.44 ICOR (Incremental Capital-Output Ratio) – the average ICOR during 2013 and 2017. Under this scenario, between 2018 and 2030, the investment-GDP ratio has to be increased annually by 0.73 percentage points which is 171 percent higher than the annual average percentage points rise of 0.42 during 2013-2017. There is no denying that for such growth acceleration and high investment requirement, there will be the need for a much larger contribution from the private sector in raising the investment-GDP ratio.

How to boost the private sector investment in Bangladesh to achieve the much larger GDP growth target? There is a need to address several policy-induced challenges. Further reform of trade policies is needed with strategic and dynamic industrial policies aiming at rapid expansion and diversification of the economy through large-scale domestic and foreign investments. Also, the crisis of the banking sector in Bangladesh is not conducive for private sector investment. There is a need for undertaking meaningful and effective remedial measures against the irregularities in the banking sector to enhance the confidence of the private sector. Furthermore, the tax system in Bangladesh is still a revenue-oriented tax policy, not a development-oriented tax policy, and thus it requires a major overhaul.

A number of supply-side constraints in the form of weak infrastructure and the high cost of doing business need to be addressed within a short time span. Bangladesh has not even been able to attract much foreign direct investment (FDI) even by the LDC standard. In 2016, the FDI share in GDP in Bangladesh was only 0.9% against the LDC average of 3.3%. Weak infrastructure and poor business environment are critical problems for Bangladesh to attract both domestic private investment and FDI. According to the 2019 Doing Business index of the World Bank, Bangladesh ranks 176th among 190 countries. In terms of sub-components of the Doing Business index, Bangladesh’s worst performances are observed in the areas of ‘enforcing contracts’, ‘getting electricity’ and ‘registering property’. There is a need for rapid improvement in these areas. The initiatives taken by the Bangladesh government in setting up 100 special economic zones (SEZ) as well as the development of big infrastructural projects seem to address these issues. However, there is a need for faster and quality implementation of these projects, as delay in implementation, cost overrun, and sub-standard quality of projects are long-standing problems in Bangladesh which discourage private investment. The current level and quality of human capital in the country discourages enhanced private investment. There is a need for undertaking meaningful and effective remedial measures against the irregularities in the banking sector to enhance the confidence of the private sector. The public spending on education and health as percentages of GDP in Bangladesh are among the lowest in the world. The country, therefore, needs to attach vital emphasis on improving the existing low level of human capital by enhancing investment on education, skill development, and health facilities.

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How does public investment affect private investment?

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The importance of investment in economic growth is well acknowledged both in theory and empirical literature. No country has been able to accelerate economic growth without significantly increasing the investment-GDP ratio. However, there are disagreements among economists and policy-makers about the composition of investment, i.e., the share of private and public investment in total investment. Two views dominate in this regard. One view argues that public investment has a crowding out effect on private investment. That means, with the rise in the public investment, the private investment may fall. In contrast, the other view argues that public investment can be complementary to private investment. Thus, the rise in the public investment can be conducive to the rise in private investment. The inconclusive nature of the results of the empirical literature is, however, also driven by the differences in the methodology used in these studies in different country contexts.

The data on public investment share in GDP is available for 91 countries. Figure 1 presents the average percentage share of public investment in GDP for those 91 countries for the years during 2013-2017. With a share of 20.77%, Republic of Congo is at the top of this list, while with a share of 0.98%, Sudan is at the bottom of the list. The top ten countries with the high shares include Republic of Congo, Iraq, Rwanda, Equatorial Guinea, Venezuela, Ethiopia, Timor-Leste, Djibouti, Burkina Faso, and Mozambique. In contrast, the bottom 10 countries include Sudan, Yemen, Lebanon, Guatemala, Russia, El Salvador, Armenia, Serbia, Philippines, and Croatia. Among the five South Asian countries, Bhutan has the highest share (10.86%), followed by Bangladesh (6.82%), Nepal (5.78%), Pakistan (3.74%), and India (3.6%).

While looking at the pattern of the cross-country differences of the share of public investment in GDP and GDP growth rate, as plotted in Figure 1, it appears that in the recent years (2013-2017), 19 countries exhibit having shares of public-investment in GDP of 5% or more as well as GDP growth rate of 5% or more. Among these countries, 10 are from sub-Saharan Africa, two from Latin America, two from South Asia (Bangladesh and Bhutan), and two from Southeast Asia (Malaysia and Myanmar). If we consider the 6% GDP growth rate as the cut-off mark with public investment share in GDP of 5% or more, there are only eight countries (Rwanda, Ethiopia, Djibouti, Lao PDR, Myanmar, Guinea, Bangladesh, and Cote d'Ivoire). This suggests that the association between public investment share in GDP and GDP growth rate is not straightforward. Furthermore, the scatter-plot between the ratios of public investment to GDP and private investment to GDP (Figure 2) suggests that there are two different trends as far as the association between the public and private investments in a cross-country context is concerned. For the countries with public investment to GDP ratio of less than 7%, there seems to be a negative association between the ratios of public investment to GDP and private investment to GDP. However, for the countries with excessive public investment to GDP ratio (more than 7%), there seems to be a negative association between public and private investment. The aforementioned analysis underscores the need for a discussion on some critical factors which are important to make public investment conducive for private investment. While it is true that public investment is the main channel for the formation of public capital stock, an adequate level of public capital can have a positive impact on economic growth depending on the capacity and nature of public capital to attract or crowd-in private capital. The crowd-in effect can only occur when public investment furnaces such a public capital stock that increases the rate of return of private capital.

One of the critical channels through which public investment may play a role in increasing the rate of return of private capital is infrastructure development. The importance of infrastructure originates from the fact that it provides key intermediate consumption items in the production process for almost all activities in the economy. Therefore, an adequate supply of infrastructure through public investment has the potential to crowd-in private investment. However, when it comes to infrastructure development through public investment, there are two important issues which need to be in order to ensure the crowd-in effect of private investment. First, not only the quantity, but also the quality of the infrastructure is equally important. In many developing countries, due to institutional deficiencies, infrastructural projects suffer from huge cost and time over-run, which can discourage private investment. The high cost of infrastructural projects and uncertainty in the timely delivery of such projects may reduce the rate of return of private investment.

Second, while several supply-side constraints related to weak infrastructure can restrict potential private investments in new and emerging sectors, some of these constraints are broadly ‘general’ in nature and some are critically ‘sector-specific’. Interconnection and complementarities between general and sector-specific infrastructures are key elements for increasing service efficiency, supporting the adoption of innovative technologies, and the promotion of private investment in these sectors. However, there is a tendency in the developing countries to excessively emphasize on the broad general infrastructure, i.e., the enhanced supply of electricity; improvement in roads, improvement in port facilities, etc., that the development of critical sector-specific infrastructure is largely overlooked. Embarking on developing broad general infrastructure are relatively easy, whereas solving sector-specific infrastructure problems involves identifying priorities in the policy-making process and addressing a number of political economic issues. However, failure to deal with sector-specific infrastructure problems leads to a scenario where a large number of potential growth-enhancing sectors may fail to enjoy the benefit from the improvement in broad general infrastructure. This can discourage private investment.

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Political Economy of Special Economic Zones: China vs India

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According to the World Bank in 2008, a modern day Special Economic Zone (SEZ) typically includes a “geographically limited area, usually physically secured (fenced-in); single management/administration; eligibility for benefits based upon physical location within the zone; separate customs area (duty-free benefits) and streamlined procedures”. For that, practices related to business and trade differ from rest of the country and therefore, all units therein get special privileges. SEZs can generate both static and dynamic benefits. Static benefits include employment creation, export growth and rise in government revenues; whereas dynamic benefits include economic diversification, innovation and transfer of technology through Foreign Direct Investment (FDI) and skills upgrading. However, good governance, proper political and investment conditions for business and timely order of work is quintessential for a successful SEZ. The successes of SEZs in China made other South Asian countries like India to succumb to the Chinese SEZ model. The noteworthy principles of this model resulted in a poor performance of India’s SEZs though.

In 2016, Chinese SEZs have contributed 22% of China’s GDP, 45% of total national FDI and 60% of exports. These SEZs also have increased the income of participle farmers by 30% and accelerated industrialization into agricultural modernization and urbanization. Whereas for India, SEZs contributed only 3.72% of GDP and 20% of exports. The most astounding fact is that only 223 are operational out of 420 approved SEZs. Furthermore, only 40% of the total lands acquired for SEZs are in use. Most of these lands were deliberately taken out from agricultural production to apt with quicker economic growth.

Chinese experience with SEZs has indicated a number of factors that contribute to their success and effective operation. For example, SEZs need to be linked to economic opening and capitalize on innovation, political stability, promote industrial expansion, building brands, incubating local ideas by integrating learning, bringing together resources and expertise from government, industry and research institutions to move into more advanced value chains etc.

The ease of doing business index by the World Bank shows fundamental differences in incubating businesses between China and India. One can argue that India started economic reforms and initiated SEZs much later than China. Although that is a very small fraction of caveat that India faces if not minimal. A few of the major reasons for slow growth of Indian SEZs are lack of diversification of products, unstable fiscal incentives due to changing regimes and their belligerence towards policies from previous regime, poor infrastructure, political patronage and delay in environmental clearance and approval by state governments.

However, the low performance of Indian SEZs can be looked at from a political economy perspective. With better than ever infrastructure and geographically ideal position, China offers something more than that India could offer to the international market. We know that China is a one-party political system whereas India is a multiparty democracy. From the viewpoint of an investor, Chinese market is way more lucrative than India in terms of political stability and investment environment. Of course, it is not always true that an authoritarian system can incubate better economic system (take Idi Amin’s Uganda for example). However, China’s performance has assured investors to rely on its economic system even since it has opened its door to a market economy. Thus, political stability along with better business environment helped China to attract the flood of foreign investment unanimously. In case of India, SEZ rules have been amended at least seven times since its initiation in 2010. These changes are concomitant with the caveats of regime changes that, in turn, changes most of the policies and acts because of internal rivalries between political parties. On top of it, as mentioned, bureaucratic complexity has made it more difficult for investors to easily start a business in India. Unjust land acquisition without feasibility studies raises questions. Perhaps, some of these are answered when some lands acquired for SEZs are sold at a higher-than-market rate by political activists.

Drawing from the discussion, it can be stated that undoubtedly political stability and understanding between political parties to ensure economic success for a country is the primary incentive for an SEZ’s success. Learning from SEZs in India, a lineation of rivalry between political parties in a multiparty democratic system is a must if we want to parallely increase economic stability with the help of SEZs. To bolster effective SEZs, well monitoring of the mechanisms with inclusive functioning cannot be negated.
SANEM is a non-profit research organization registered with the Registrar of Joint Stock Companies and Firms in Bangladesh. Launched in January 2007 in Dhaka, it is a network of economists and policy makers in South Asia with a special emphasis on economic modeling. The organization seeks to produce objective, high quality; country- and South Asian region-specific policy and thematic research. SANEM contributes in governments’ policy-making by providing research supports both at individual and organizational capacities. SANEM has maintained strong research collaboration with global, regional and local think-tanks, research and development organizations, universities and individual researchers.

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