



Regulatory Framework for Private Investment in Bangladesh

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A. Overview

The regulatory environment for business can have a determining influence on private investment. Complex regulations and bureaucratic hurdles tend to increase the transaction costs of doing business and thereby hurt the growth of investment. On the other hand enabling regulations that protect investor interests and simplify business transactions encourage private investment. In today's globalized world where capital is fairly mobile, weak domestic investment climate riddled with too many regulations and bureaucratic hurdles will adversely affect the inflow of foreign investment and cause domestic capital flight to more hospitable investment environment.

The development experience of South Asia, especially India, provides an important example of how regulatory burden can overwhelm and choke private investment. While all South Asian economies started their development journey on the wrong footing with an over-dose of regulations, the Indian investment climate for private investment in particular had the dubious distinction of being dominated by the "license raj". Subsequent deregulation drive in India since the 1980s ushered in a sea change in the investment climate for private

investment that led to a major private sector led growth experience.

B. Lessons of Bangladesh Experience

Per capita GDP in Bangladesh has grown at a steady pace since independence in 1972, climbing from an average of below 2% during 1974-1990 to 5.0 % in 2010-14. The acceleration of per capita GDP during 1991-2014 is remarkable and it laid the foundations for Bangladesh to move towards low middle-income status. A review of determinants of growth shows that the accumulation of capital was the most important factor. The investment effort in both public and private sectors started rising from the very low base in the early 1970s but remained weak well until 1989 hovering on average around 5-6% of GDP for each. The public investment effort funded through generous official development assistance (ODA) gained some momentum until 2000 but moved to a declining path as ODA flows fell and public resource mobilization effort did not gain adequate speed. Indeed, this trend continued until 2009 when the public investment rate fell to a low 4% of GDP, down from 7.4% in 2000.

There has been some recovery in public investment since 2010, but growing only to 5.7% of GDP in 2014.

On the other hand, the private investment effort accelerated after 1989 in response to the initiation of various liberalization measures, especially investment deregulation. Private investment climbed from a low of 6% of GDP in 1989 to 20% of GDP in 2009. In many ways these 20 years transformed Bangladesh from a public investment driven and regulated economy to a private investment led economy. Unfortunately, however, over the past 5 years the private investment momentum has shown signs of stagnation at the 20-21% of GDP. Another concerning factor is that the while response from foreign direct investment (FDI) has been positive, overall performance is lack luster. For example, as compared with \$1.6 billion FDI inflow in Bangladesh in 2013, FDI inflows amounted to \$124 billion in China, \$29 billion for India, \$18 billion for Indonesia and \$9 billion for Vietnam.

The rapid growth in private investment rate from 6% of GDP in 1989 to 20% in 2009 did not happen by accident. A number of good policies including sound macroeconomic management, trade and investment deregulation, the expansion of infrastructure services and expansion of labor and quality improvements contributed to that effort.

Prudent macroeconomic management: Barring the early years of independence, sound macroeconomic management has been a hallmark of economic policy making in Bangladesh. The long term trend of various macroeconomic management indicators shows a facilitating environment for the expansion of private investment. These include low fiscal and current account deficits, prudent monetary policy, and flexible management of the exchange rate. As a result, the long-term inflation rate has been in single digit, real interest rate has been relatively stable and the real exchange rate has avoided extended periods of real appreciation. Total debt to GDP ratio is low and declining and external indebtedness is very manageable.

Investment deregulation: In the 1970s and 1980s Bangladesh manufacturing and organized services were characterized by a domination of state-owned enterprises and state controls over prices, investment and external trade. The deregulation process started in the 1980s but gained momentum after 1989. The deregulation effort has involved privatization, removal of quantitative restrictions, simplifying business registration process and encouraging foreign investment through relaxation of ownership restrictions. Foreign currency restrictions on inflow of foreign investment and outflow of profits have also been progressively eased including very recently foreign private borrowing for investment, although there is scope for improvement.

Trade liberalization: This involved virtual dismantling of almost all quantitative restrictions on trade, sharp reduction of average trade tariffs and the establishment of the free trade zones (Export Promotion Zones (EPZs)). The hugely positive response of the readymade garments (RMG) sector to trade liberalization and related other policies (such as back-to-back LCs, fiscal incentives and access to concession trade finance) is illustrative of the role trade liberalization in promoting investments, exports, GDP growth and employment.

Fiscal incentives: To attract foreign investment and promote domestic investment the Government offers a fairly liberal set of fiscal incentives involving tax holidays, lower income tax rate, accelerated depreciation and low import duties on capital and intermediate goods imports. Exports also enjoy duty drawback benefits.

Supply of labor and employment policies: The abundant supply of labor is a major positive contributor to private investment and expansion of manufacturing production and exports,

especially in RMG. Low wage cost remains a major advantage for Bangladesh that contributes to cost competitiveness in labor intensive manufacturing such as RMG. Government policy in regards to education and labor markets has played an important facilitating role. Bangladesh labor markets relating to all three major sectors (agriculture, manufacturing and services) work flexibly and the transaction costs of employment in terms of hiring, termination and wage setting are among the lowest in developing countries and certainly within South Asia. While this flexibility is a big plus, recent developments in the RMG sector suggest that the absence of prudential regulatory norms regarding worker safety and social insurance including coverage of accidents is a serious problem that needs to be corrected.

C. Emerging constraints to private investment

The above analysis suggests that the returns to good policies can be substantial. But it also begs two questions: first, why the FDI response in Bangladesh has been sluggish in comparison with the dynamic Asian economies? ; and second what explains the stagnation of the private investment rate over the past few years? The answers to these two questions are inter-related and can be obtained by reviewing the emerging constraints to investment.

In recent years a range of cross- country indicators of investment climate are regularly prepared on an annual cycle by specialized international agencies based on investor surveys.

Two well known indicators are the Global Competitiveness Index (GCI) prepared by the World Economic Forum and ease of Doing Business (DB) indicators prepared by the International Finance Corporation. The GCI measure is available as a composite index as well as by individual components that comprise the index. The individual components (12) provide fairly in-depth views about the regulatory environment faced by investors in any country as well other factors affecting competitiveness including macroeconomic environment, financial services, skills, infrastructure, institutions and technology.

The trend in overall competitiveness of Bangladesh as measured by the GCI in relation to its competitors between 2008 and 2014 show that: First, China, Indonesia, India, Vietnam and Sri Lanka are much more competitive than Bangladesh. And second, between 2008 and 2014 Bangladesh has made some progress with improving its competitiveness, but China, Indonesia, Vietnam and Sri Lanka have improved faster. As a result, the competitiveness gap with these countries has widened. The one exception in competitiveness performance is

Pakistan. In 2008 Pakistan was well ahead of Bangladesh but it deteriorated sharply over the past 6 years and has now fallen much behind Bangladesh.

The DB indicators provide an overall ease of doing business index ranking as well as rankings for 10 regulatory areas that affect business decisions. The overall DB index for 2015 for Bangladesh and comparators based on 189 countries suggest some interesting results. First, despite past progress, the regulatory environment in Bangladesh is substantially less favorable than competitors; it is ranked at a low score of 171 as compared with the worst performing country ranking of 189 for Chad. Second, all other countries in the comparator list have a relatively better regulatory environment than Bangladesh. And third, while the regulatory environment is an important determinant of the investment climate and competitiveness of an economy, it is only one determinant. It is also important to pay attention to such other factors included in the measurement of GCI as the macroeconomic environment, labor skills, labor market, financial sector, infrastructure, technology, institutions and innovation. Progress in these other areas can compensate for the higher transaction costs of negotiating the regulatory environment while weaknesses in these other areas can strongly offset the regulatory ease of doing business (Bangladesh versus Pakistan). Nevertheless, the inescapable conclusion is that the overall investment climate for private sector is weak in Bangladesh by both measures (GCI and DB) and the best approach to reforming policies for improving the investment climate is to focus attention on both the regulatory environment as well as other enablers.

Drilling down the composite DB index by its 10 individual components provides substantial insights of where the main regulatory constraints bite most. The three biggest constraints are getting electricity, enforcing contracts and registering property. The ranking in these areas, especially in regard to getting electricity and enforcing contracts, puts Bangladesh at the near bottom of the global list of countries. Trading across borders, resolving insolvency and getting construction permits are also problematic and involve substantial transaction costs.

The implications of these rankings in terms of transaction costs, measured in terms of number of procedural requirements, the amount of time involved in meeting the regulatory requirements, and some measure of financial cost of complying with the regulation, getting electricity and registering property is unduly complex, time consuming and expensive. The high transaction costs of compliance with the regulatory regime in these three areas are a

fundamental reason for the very low ease of doing business ranking and the relatively low inflow of FDI in Bangladesh. In some sense, these three issues are a binding constraint to FDI because local investors would likely have a way to get through with their local knowledge and connections, while foreign investors will be heavily disadvantaged.

For example, on average it takes 1442 days to enforce a contract and the financial cost of enforcement is as high as 67% of the claim. As compared with this, it takes only 400 days in Vietnam and 453 days in China to enforce a contract; the financial cost is 29% and 16% respectively. The performance gap between Bangladesh and the best performer is commensurately much larger: 150 days to resolve a conflict involving only 9% of the cost of claim. The difficulty of getting access to electricity is equally telling. It takes 429 days to get access to electricity in Bangladesh as compared with 91 days in Indonesia, 104 days in Sri Lanka, 106 days in India, 117 days in Vietnam. Additionally the relative cost of getting electricity measured as percentage of per capita GDP is much higher in Bangladesh relative to comparators. The performance gap with best practice is huge. Regarding, property registration, Bangladesh takes 244 days while it is only 20 days in China, 27 days in Indonesia and 47 days in India. The transaction costs of resolving insolvency and trading across nations are similarly high in relation to the comparators.

D. Policy Implications

These high transaction costs in key areas of policy making affecting business decision even after significant deregulation since the 1990s are indicative of an important aspect of the weakness of the private sector regulatory environment that has not received adequate attention. Much of the effort so far has focused on deregulating and simplifying bureaucratic interventions in private investment decisions. But there are a number of areas where investment facilitation requires enabling regulations and enforcement. The inadequacy of legal framework for contract enforcement and resolving insolvency are two primary examples of the absence of appropriate enabling regulations. Another important area is labor protection laws. However, the low DB ranking is also indicative of the fact that most other countries have moved much faster than Bangladesh in improving the investment climate.

The relative stagnation in the private investment rate despite very favorable macroeconomic performance and robust economic growth are indicative of the investor concern with the business environment that has made progress but falls short considerably in relation to other

countries. The highest priority is to address the three binding constraints: contract enforcement; getting electricity; and property registration. Additionally, policy focus is required in the matter of resolving insolvency and lowering the cost of trading across border.

Contract enforcement and resolution of insolvency are indicative of weak procedures and inadequate implementation capacity and or lack of responsiveness in the concerned public agencies. There is an urgent need for the Government to first review the legal framework to check adequacy of these two important enabling regulations in light of international good practice. Based on that review, appropriate steps have to be taken to streamline and strengthen the related regulations. This is a first step. The other important reform is to ensure that adequate administrative and legal procedures are in place to enforce the sound implementation of these regulations. Once again, the Government can learn from the experience of good practice examples how business disputes are resolved and how bankruptcy proceedings are implemented. This review can then inform what actions are needed to enforce proper implementation, including whether there is a need for separate legal entities to resolve business disputes.

Regarding access to electricity, the high transaction costs reflect mainly the inadequate supply of electricity relative to demand. Despite considerable new investments in power generation, getting electricity connections for new investments is a challenging exercise as reflected in the responses to business surveys. This problem cannot be solved by a simple deregulation drive. While the regulatory procedures needs to be further simplified by reducing the number of procedures and response time to applications, the ability to actually respond to new requests for electricity connection in the required volume and with lower financial cost will depend critically upon enhancing supply capabilities. The resolution of this constraint requires both substantial additional investment and the implementation of a well thought out primary energy supply strategy.

Concerning property registration, the long delays and high cost are reflective of another binding constraint to private investment: the availability of land for manufacturing enterprises. The land market is very inefficient in view of weak land ownership data, lack of computerization of land records, poor zoning laws, and high transaction cost. On top, population pressure and rapid urbanization have contributed to a growing scarcity of urban land. As land prices have sky rocketed so have land disputes and various forms of corruption

including land grabbing. The challenge for policy is acute and a resolution will take a long time. A range of policy actions are needed here including regulatory reforms to simplify land transactions and registration; institutional reforms to improve land administration and record keeping; investment in economic zones to provide land for domestic and foreign private investors; and enforcement mechanisms to enforce land use zoning laws.

Finally, regarding trading across border, the lower ranking on this count despite substantial trade liberalization reflects the considerably longer delays in trade transactions and associated costs related to weakness of trade logistics. Much of the problem lies in internal transport between factory gate and the port. The Chittagong port's handling capacity has improved and port handling charges are less of a concern. But the inadequacies of the railway connection from Chittagong Port to factory destinations across the country and the road congestions on the major highways are of serious concern. The transport problem is a third binding constraint to the acceleration of private investment that needs urgent resolution. The Government has taken a number of initiatives to ease the problems, but progress with implementation of railway reforms and completion of road projects are lagging behind substantially.