Harnessing competitiveness for stronger inclusive growth

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Second Investment Climate Assessment

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GOVERNMENT’S FISCAL YEAR
July 1 – June 30
Abbreviations and Acronyms

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<th>Description</th>
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<tr>
<td>ACC</td>
<td>Anti Corruption Commission</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>ATC</td>
<td>Agreement on Textiles and Clothing</td>
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<td>BBS</td>
<td>Bangladesh Bureau of Statistics</td>
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<td>BEPZA</td>
<td>Bangladesh Export Processing Zones Authority</td>
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<td>BERC</td>
<td>Bangladesh Energy Regulatory Commission</td>
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<td>BGMEA</td>
<td>Bangladesh Garments Manufacturers and Exporters Association</td>
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<td>BOI</td>
<td>Board of Investment</td>
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<td>BRAC</td>
<td>Bangladesh Rural Advancement Committee</td>
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<td>BSTI</td>
<td>Bangladesh Standards and Testing Institute</td>
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<td>BTRC</td>
<td>Bangladesh Telecom Regulatory Commission</td>
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<td>BTTB</td>
<td>Bangladesh Telegraph and Telephone Board</td>
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<td>C &amp; F</td>
<td>Clearing &amp; Forwarding</td>
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<td>CCT</td>
<td>Chittagong Container Terminal</td>
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<td>CFO</td>
<td>Central Filing Office</td>
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<td>CIB</td>
<td>Credit Information Bureau</td>
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<td>DCC</td>
<td>Dhaka City Corporation</td>
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<td>DFID</td>
<td>Department for International Development</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FTE</td>
<td>Full Time Equivalent</td>
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<td>HIES</td>
<td>Household Income and Expenditure Survey</td>
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<td>ICA</td>
<td>Investment Climate Assessment</td>
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<tr>
<td>ICT</td>
<td>Information and Communication Technology</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IFC-BICF</td>
<td>IFC-Bangladesh Investment Climate Fund</td>
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<td>IFC-SEDF</td>
<td>IFC-South Asia Enterprise Development Facility</td>
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<td>IPP</td>
<td>Independent Power Producer</td>
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<td>ISO</td>
<td>International Organization for Standardization</td>
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<td>JAO</td>
<td>Judicial Administrative Officer</td>
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<td>MDG</td>
<td>Millennium Development Goals</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<td>MIC</td>
<td>Middle Income Country</td>
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<td>MSE</td>
<td>Micro and Small Enterprise</td>
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<td>MSME</td>
<td>Micro, Small and Medium Enterprise</td>
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<td>NBR</td>
<td>National Board of Revenue</td>
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<td>NCB</td>
<td>Nationalized Commercial Bank</td>
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<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>NMICS</td>
<td>Non-Metro Investment Climate Survey</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>RAJUK</td>
<td>Rajdhani Unnayan Kartripakkha (Capital Development Authority)</td>
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<td>RMG</td>
<td>Ready Made Garments</td>
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<td>SAR</td>
<td>South Asia Region</td>
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<td>SME</td>
<td>Small and Medium Enterprise</td>
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<td>SMLE</td>
<td>Small Medium and Large Enterprise</td>
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<tr>
<td>TFP</td>
<td>Total Factor Productivity</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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<td>Isabel Guerrero</td>
<td>SARVP</td>
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<td>Country Director</td>
<td>Xian Zhu</td>
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<td>Sector Director</td>
<td>Ernesto May</td>
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<td>Simon Bell</td>
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<td>Task Leader</td>
<td>Tatiana Nenova</td>
<td>SASFP</td>
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FOREWORD

Bangladesh has recorded impressive economic and social gains since the 1990s. Recent growth has been at levels close to six percent. The country has doubled per capita growth and taken large strides toward reaching many Millennium Development Goals (MDGs), ahead of many comparable countries. Attaining the MDGs calls for accelerating economic growth to 6-7 percent a year. Accordingly, Bangladesh’s Poverty Reduction Strategy Paper (PRSP), “Unlocking the Potential,” puts into sharp focus the need for investment climate improvements, as well as inclusive growth and empowering the poor.

Accelerating growth will require greater investment – to aid diversification into areas of comparative advantage and to finance infrastructure – and higher productivity. This in turn calls for a substantial improvement in the investment climate. The strategy as laid out in the PRSP promotes an enabling business environment as a key to Bangladesh’s development – by improving trade policies, enhancing the legal and regulatory environment for the private sector, developing an effective competition policy, establishing policies friendly to foreign direct investment, and deepening financial sector reforms. Addressing labor skills and education is critical to improving productivity. Improvements in the policy environment for energy development are central to this effort, by strengthening the institutional framework, addressing distorted pricing, and encouraging accountable and transparent processes for investment decisions. Equitable growth and empowerment of the poor further call for strengthening of high-growth rural and peri-urban areas with natural potential, via services and infrastructure provision to such promising growth poles.

With sustained growth, the scarcity of certain resources (energy, finance, land, labor skills) has started to strain the economy’s growth and productivity gains. Along those lines, we hope that this report will highlight successful strategies to unblock bottlenecks in basic resource markets and the investment environment, informing the policy dialogue and allowing for the economy and development of Bangladesh to forge ahead in a rapid, robust, and socially equitable manner.

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How can we enable business to bring about jobs and prosperity?

Bangladesh: Second Investment Climate Assessment

Executive Summary

What is new in the 2007 ICA for Bangladesh?

The Second ICA takes a more comprehensive look at the business environment by extending beyond Dhaka and Chittagong, permitting locational choice issues to be explicitly addressed. The expanded coverage also goes beyond the urban areas to assess the investment climate in non-metropolitan areas and for the rural non-farm sector, and allows an analysis of the importance of rural-urban linkages and spillovers. The 2007 report also looks beyond manufacturing to the services sector, which represents 52% of GDP and is the largest source of employment for women. The study further makes use of the newly available panel data to evaluate the impact of recent reforms in a dynamic analysis.

What has driven growth in Bangladesh?

Bangladesh has grown at a steady rate of around 6% in the past 5 years, poverty has fallen significantly, and the Millennium Development Goals (MDGs) have been on track with more success than in comparable countries. Macroeconomic stability has been broadly maintained, though high and rising inflation is the main concern. Political stability and good governance have proven to be critical factors affecting the health of the Bangladeshi private sector.

The structure of the economy had been moving away from agriculture, with industry becoming the second largest sector in the economy in 2001. Growth in the manufacturing sector has been robust at 11.4 percent in FY2007. Rising incomes in Bangladesh are spurring consumerism and the services sector, which is further fuelled by urbanization and remittances. Urban and rural areas display vastly different characteristics, strengths, and issues, suggesting the need to avoid a one-size-fits-all approach.

Productivity growth during the 2003-2007 period, as before 2003, was below potential, with inefficient allocation of resources even within the most productive sectors. For example, whereas most resources are channeled to larger and older firms, who are also more likely to enjoy economies of scale and learning by doing, analysis shows smaller and younger firms to be more productive in spite of more adverse investment climate conditions. Older and larger firms are less productive as they are protected from competition and face little incentive to innovate and improve. Weak financial markets also prevent resources from flowing to more productive smaller firms.

The external sector has been strengthened by continued robust performance of exports and remittances, and further growth would rely on successful improvements in quality and safety standards, labor and management skills. Private sector investment has been maintained at 16.4%, through higher levels are needed to reach growth rates of 7-8%. Higher investment levels domestically would depend on the ability of the financial system to fulfill its term transformation role. FDI net flows are below potential at 1.3%; higher foreign capital flows will be attracted via further improvements in infrastructure, governance, and the regulatory environment. Greater competition is spurring innovation, as firms have started investing in technology and ICT, as well as creating pressures for improved labor skills, as the private sector strives for productivity improvements.

With sustained growth, the scarcity of certain resources (energy, finance, land, labor skills) has started to put a strain on the economy’s further growth and productivity gains, as factor markets have not risen up to the challenge of efficiently reallocating resources to the highest productivity entities within the economy. Reallocation of resources to the MSME sector, a considerable source of productivity gains, employment growth, and poverty reduction, had been particularly poor.

The top five investment climate constraints, in the opinion of metropolitan firms, were electricity, political instability, governance, access to land, and access to finance. For non-metropolitan firms,
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These were low levels of demand for goods and services, rising inflation pressures, seasonal inaccessibility of roads, and the cost of finance. Some of the key investment climate areas are overviewed below:

- **Electricity** supply has struggled to keep up with demand spurred by solid economic growth. The private productive sector reports significant losses as a result of power scarcity. The issue is particularly detrimental to MSMEs who cannot afford generators. Manufacturing firms blame the low capacity utilization primarily on scarce power. Estimates put the cost of electricity shortages to Bangladesh at as much as 2 percentage points of annual GDP growth. Private power producers are more efficient and cost-effective; whereas state provision suffers from problems in governance, accountability, financial management, bad debt and collection rates, as well as physical capacity. The Bangladesh Energy Regulatory Commission is operational and needs strengthening. The recent unbundling of distribution companies, and their corporatization is expected to bring improvements. The potential of public-private partnerships in the power sector is being explored. Several recent initiatives have been promising - commercial losses have been reduced somewhat, financial strengthening and restructuring of power utilities is underway, and power supply reliability has also improved, with some decrease in load shedding.

- **Bold reforms to the Bangladesh financial sector** have resulted in a declining importance of nationalized banks and rapid growth in bank assets. Bangladesh compares favorably with its peers in terms of domestic credit to the private sector, though long-term lending as well as lending to smaller firms and firms in the rural non-farm sector has remained inadequate. The financial sector lacks the modern lending techniques and ICT-based operational efficiency to service the MSME demand. A new “downscaling” lending approach is needed, based on risk and credit information, not collateral. A new, modern set of financial services and a variety of products with varying characteristics to suit client preferences is needed by the vast majority of firms, who cannot qualify or are not interested in the traditional collateral-based loan. Only a modern approach to finance will enable the enterprises, especially MSMEs who are engines of employment growth and poverty reduction, to thrive, create employment, and help raise the incomes of the poorest.

- **Serviced land** is the single defining (or limiting) factor of new or expanding entrepreneurs. Smaller firms are cut off more severely from access to land. The cost of land, procuring the land and the availability of serviced land are among the most pertinent preoccupations. Titling and registration of land are major problems - property registration procedures are long (425 days in Dhaka). Jurisdiction of land administration is divided between the Ministries of Law and Land, with little or no coordination, and with municipal development bodies, such as RAJUK, also playing an important role. Procedures are manual, and complex, and mired in red tape and delays. Reforms of land registration / titling and use rules have started, including the amendment of the Land Registration Act and undertaking the Demra pilot on land records computerization, which is intended for replication nationally. Registration fees and stamp duties are some of the highest in the region. Land and building financing is very limited for longer-term commercial mortgages. Private sector growth and the exigencies of food security are twin major arguments for promoting policies to develop industrial / special economic zones, to balance the land needs by industry and agriculture, ensuring simultaneous achievement of both.

- Bangladesh’s manufacturing **labor** is competitive, and has been growing fast, but is of low productivity. Despite light labor regulations, **labor skills shortage and mismatch** impair the efficiency of the labor market. Improving labor skills requires strengthening of higher education, and short-term stop gap vocational training measures. One promising initiative is the fully self-financed BGMEA Institute of Fashion and Technology, established by the Bangladesh Garments Manufacturers Export Association to meet the training requirements of its industry. Further, the government has supported a new initiative for building a National Vocational Skill Center.

- **Female workers** face considerable differences in employment terms, and there appears to be a high degree of gender segregation in the labor market. The rates of **female entrepreneurship** in metropolitan firms Bangladesh are comparable to those in other South Asian countries, but are lower among rural non-farm enterprises. Non-metropolitan enterprises owned by women are smaller,
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younger, more likely to be informal and home-based. Female entrepreneurs are less educated and have significantly less access to enterprise finance. Attention to developing female labor skills and access to finance are vital to address gender issues in Bangladesh.

- Connectivity to markets, in terms of market linkages, transport, telecommunications, financial, technological and information exchange, is vital for the growth of peri-urban, small town, and village areas. Low demand is perceived as the most serious obstacle to doing business in non-metropolitan areas, linked significantly to low access to larger markets. Infrastructure bottlenecks, and limited subcontracting due to poor contract enforcement, and low quality of production compound these problems. The numerous NGO and donor projects focusing on business development in need of evaluation, to scale up the approaches that deliver the best results. Interventions that strengthen linkages between micro and small enterprises and larger firms would also be beneficial. Telecommunications are important for markets connectivity, mobile banking, as well as ICT and Internet development. Bangladesh is presently one of the top ten mobile phone growth markets in the Asia-Pacific region. The low penetration of landline telecommunications has impeded the development of the IT and software industries, and has deprived the country of ICT-induced governance improvements. The private sector has taken on a growing role in transport, bringing improvements in sector performance. Domestic financing of road maintenance is inadequate, and regulatory procedures remain complex. The railway network is facing increasing competition from a developing road network and high-capacity trucks, and needs improved financial and operating efficiency. Competition is strong in inland water transport, where services are provided mainly by small private operators. Non-metropolitan enterprises identified inaccessibility of roads during certain seasons as a major/severe constraint.

- Weak innovation and low investment in technology constrains productivity enhancements in both rural and urban areas, governance and efficiency improvements. Innovation can be spurred by increasing both domestic and foreign competition, as firms strive for better performance and market share. Interaction with foreign firms promotes technology and other spill-overs.

In sum, to sustain and increase growth, recent rising inflation must be addressed, FDI and export competitiveness must be stimulated, stronger investment and productivity increases are needed, and the pressure must be eased on the country’s infrastructure and factor markets for land, skilled labor, and financing for long-term investment and for MSMEs. To stimulate both domestic and foreign investment sustainably, improvements in the business environment are needed (including property registration, contract enforcement, and governance), as are power infrastructure and land enabling policies. For productivity, labor skill and innovation/ICT would need to be deepened. The financial sector would need to step up its term transformation role, and develop new lending products suitable for the MSME sector. Local government decentralization and location planning policies would be needed to realize agglomeration economies away from the biggest urban centers, and connectivity to rural markets would need improvement.

What has changed over the past five years?

In the past five years, there have been some positive government reforms, including improvements in customs rules and processing times, import / export rules for certain sectors, reduced crime, increased regulatory and tax compliance. Further advances were achieved in municipal licensing (Dhaka City Corporation), Chittagong port operation, and e-government improvements of Board of Investment and Bangladesh Export Processing Zones Authority. The effects of NBR modernization efforts have started to bear some fruit: collections increased by 25%, though they remain low, and procedures remain complex. Similarly, ongoing and planned reforms of land registration are in their nature long-term and remain to bring results. While power sector improvements have to go a long way in order for changes to palpably take hold (in view of the extent of the problem), efforts there are ongoing. Mobile telecom deregulation has been another very positive development. The brunt of governance reform efforts came during and after the survey, and it was too soon for businesses to express opinions, though uncertainty and some disruption were felt. Financing, and especially land and labor skills, have drastically exacerbated as obstacles to business. Labor regulations have virtually disappeared as an issue to business, though raising awareness about corporate social responsibility issues remains of considerable importance. Labor
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skills represent a considerable bottleneck to growth. R&D is increasing, albeit from a very low level, and innovation via new equipment is falling. Efforts in education are ongoing, though have not sufficiently focused on innovation-related subjects (e.g. engineering), ICT-enabling skills, and relevant labor skills.

How does Bangladesh compare internationally?

The data from the metropolitan ICA survey points to advantages of Bangladesh in comparison to other countries in terms of labor regulations, customs and import/export procedures, crime, mobile telephones, micro-finance for individuals, and licensing. The country performs weaker than international peers on courts / contract enforcement, access to land / property registration, labor skills / training, electricity, governance, access to finance (and micro-business loans), innovation / IT, and tax administration.

While quality of electricity supply and roads are bottlenecks for non-metropolitan enterprises in Bangladesh, overall infrastructure services and delivery are comparable with most of the comparator countries. The absence of business development services in non-metropolitan areas of Bangladesh is striking, with the exception of small towns. Compared to Sri Lanka and Pakistan, non-metropolitan areas in Bangladesh lag behind in terms of the level of financial intermediation available.

How do the FDI and Exports sectors perform?

Investment climate constraints are particularly relevant to the country’s attractiveness to foreign investment, which has much potential to grow. Bangladesh derives a substantial comparative advantage from its low wage base and liberal labor laws, which should allow for increased domestic and foreign direct investment. Further incentives for FDI include few restrictions on foreign ownership of business, easy registration, attractiveness to selected natural-resource-based industries; and a steadily expanding domestic market for industries like pharmaceuticals and white goods. Factors affecting negatively the FDI decision include physical infrastructure and communication, openness and low tariff structure, labor skills, revenue-raising skills of the Bangladesh government cum complex tax code subject to unpredictable changes.

The past decade’s boom in exports has boosted significantly national growth. Trading across borders has seen a number of recent improvement initiatives. Private operation and management of Chittagong Container Terminal has helped significantly improve overall handling operations and efficiency. Steady progress is being made on trade liberalization since 2002, but further simplifications in the import-tax regime are needed, as are tariff reductions. To make the most of its export opportunities in a changing international playing field, Bangladesh needs to relax further the trade regime, invest in infrastructure, technology and skills, streamline policies, and improve quality and safety standards. Several further reform opportunities include economic zone development and further streamlining of trade procedures. Delays in processing exports and imports through customs have seen an improvement as well, and could be further simplified by combining different inspections, going online, measuring delays at the border, and increasing customs bonded facilities, to allow for efficient handling and transit of legitimate import-export trade flows. Railway container services could be put on a commercial footing. The reliability of air-freight service could be improved. In addition, further investment in port equipment and streamlining of processes / fees is needed, in particular on the import side.

What are the issues with the choice for business location?

The two largest urban centers – Dhaka and Chittagong, have concentrated much of the economic activity in Bangladesh, benefiting from access to labor, public services, markets, and other agglomeration advantages. Yet there are signs that the congestion costs in some areas, particularly Dhaka are outweighing agglomeration benefits, as visible in the high land prices, commuting costs, pollution, and bottlenecks in infrastructure and service provision. The largest metropolitan area will continue to attract rapid population growth unless other urban centers become viable investment decisions, via institutional reform, provision of serviced land, enhancement of own source revenues, as well as investments in interregional infrastructure to de-concentrate standardized manufacturing. The country does not have a comprehensive policy on urbanization and urban poverty.
Cities in Bangladesh do not have much autonomy to develop policies, provide public services, and compete over the provision of hospitable conditions to attract business. Institutional reforms to improve local governance and management of recourses and costs, including in Dhaka, hold the promise of decentralization and improved potential for other cities as viable investment destinations. Specifically, municipalities should improve their revenue and budget management, infrastructure development and service provision. The ability of Pourashavas to provide local services that are valued by local residents should be enhanced. Land use and housing market reforms are needed to increase access to serviced land and address price imbalances. Further investments in inter regional infrastructure are needed to de-concentrate standardized manufacturing.

Stimulating non-farm activities in areas outside of the two main metropolitan centers -- Dhaka and Chittagong -- will be important for overall economic growth and poverty reduction in Bangladesh. Compared with Dhaka and Chittagong, other cities, peri-urban and rural areas offer many advantages in terms of availability of cheaper land and labor, and little or less congestion. Expansion of non-farm activities in those areas is also desirable from the point of view of balanced regional development and poverty reduction.

Growth of non-farm activities in areas outside of the two main metropolitan centers would require removing major constraints faced by those areas. Provision of services as well as infrastructure in peri-urban and rural areas, and small towns need to be guided by the presence of agglomeration economies along with market access. When it comes to small towns, policymakers need to re-assess the current strategy of thinly spreading resources over a large number of locations (Pourashavas and growth centers). As firms prefer rural locations with greater clustering of activities, provision of services for rural areas should target areas with natural advantage (e.g. less susceptible to flooding, lower crop suitability, larger population) allowing these areas to become rural growth poles. Investment in an efficient transport system is needed to facilitate clustering of activities in rural areas with natural advantage. Development of the transport system will rely on relieving congestion, integrating different modes of transportation, proper management of waterways, and continuing/implementing reforms in ports and railways.

What have been the trends in productivity and firm performance?

Investment in the country is reasonably high; however, the efficiency of utilization of resources is under question. Capacity utilization was low on average, primarily due to electricity shortages, working capital shortages and suppressed demand. Among the most productive firms in metropolitan areas are the garments and chemicals/pharmaceuticals industry, firms in Dhaka and Chittagong, and foreign and exporting firms. Larger firms have lower labor productivity and TFP in Bangladesh, but exhibit stronger employment growth than small firms. Firm size is not significantly associated with sales growth nor with profit margins. Older firms also display significantly lower TFP, lower labor productivity, lower sales growth, and lower employment growth than younger firms. Firms employing a higher share of skilled workers perform significantly better than other firms, as those skills enable firms to adopt new technologies, permitting also better decisions, organization, and work supervision. Investment climate has a strong effect on firm performance, with access to finance, electricity, ICT, R&D, and quality certifications contributing to productivity, while red tape and regulatory complexity, and crime affect it adversely.

Firms in peri-urban areas, small towns and rural villages are considerably less capital intensive and productive than their metropolitan counterparts. Labor productivity is highest in trading enterprises, followed by the services sector and manufacturing. Firms with more educated workers, a larger share of hired workers, access to larger local markets, better telecommunications, business network, better access to finance and electricity, are more productive. Female ownership of manufacturing and service sector firms is associated with significantly lower firm performance in multiple dimensions. The agglomeration economies also have a significant positive effect on the productivity of non-metropolitan firms.

Key Policy Issues and Options

Positive government reforms in the past five years include improvements in customs rules and processing times (for certain sectors, import / export rules as well), reduced crime, increased regulatory and tax compliance. The automation of municipal licensing with a new interface provided by the Dhaka
City Corporation (DCC) resulted in dramatic declines in the time to renew business licensing permits and accompanying governance improvements. Mobile telecom deregulation has been strongly felt. Chittagong Port operations have been overhauled. The brunt of governance reform efforts came during and after the survey, and it was too soon for businesses to express opinions, but the country improved by 15 ranks per the latest Transparency International Governance Indices. While power sector improvements have to go a long way in order for changes to palpably take hold (in view of the extent of the problem), efforts there are ongoing. The effects of NBR modernization efforts have not been felt yet in a significant way, and collections remain low, though the nominal figures have increased this year by 25%. The challenge would be to continue this trend and make it sustainable. Macroeconomic stability has been significantly improved, though high and rising inflation is the main concern, fuelled by unfavorable international price developments. Several key areas require particularly keen policy focus:

- **Modernized lending and a wider choice of loan instruments and terms beyond the collateral-based loan are needed.** Bank downscaling and modernization would permit the transition from reliance on collateral to risk-based lending, segmentation of clients by risk levels, and diversification of the lending instruments. The vast majority of bank clients cannot qualify or do not like the lending products currently on offer by the banking system. This especially includes MSMEs, for whom both mainstream products and traditional micro-finance lending are not appropriate. Lending would be based on better credit information, so as to assess client risk more precisely. Higher-risk borrowers would face a higher interest rate. Several lending products would be offered, to better suit the varied client preferences. This involves upgrades in the credit registry; collateral registry and regime, bank operations and loan administration, as well as regulations (provisioning, credit bureau reporting).

- **Improvements in land administration are critical to better land use and land markets.** To this end, policymakers should forge ahead by building on the experience of the Demra pilot in a phased roll-out of land records computerization. Land administration issues should be re-focused under a single Ministry, to improve coordination and reform effectiveness. There is further scope for reduction of registration fees and stamp duties, as well as streamlining of procedures that would result in substantial reductions in the time required to register property.

- **Addressing the labor skills shortages and mismatches require improvements in higher education, and short-term stop gap vocational training measures.** Initiatives such as the BGMEA Institute of Fashion and Technology should be encouraged. Particular emphasis should be placed on ICT / engineering skills; migrant worker skill needs; and girls’ education / gender needs.

- **Gender issues require careful and aggressive attention, via promotion of female employees’ labor skills, as well as access to finance and business support services to women entrepreneurs.**

- **Growth of non-farm activities in areas outside of Dhaka – Chittagong would require removing major constraints in provision of services as well as infrastructure.** Provision of services for rural areas should target areas with natural advantage (e.g. less susceptible to flooding, lower crop suitability, larger population). Investment in an efficient transport system is needed to facilitate clustering of activities in rural areas with natural advantage. The current strategy of thinly spreading its resources over a large number of locations (Pourashavas and growth centers) should be reassessed, in favor of a bigger push in developing medium sized cities with better natural resources and infrastructure access. As peri-urban areas are experiencing the fast growth in non-farm employment, provision of services and maintenance of infrastructure in these locations areas should be a priority. These are also areas where the rural-urban transformation is taking place and there is a need for more orderly expansion and smarter growth in these areas.

- **Market connectivity is essential for stimulating the growth of peri-urban and rural areas, including via technical assistance for micro and small enterprises on marketing and business planning and improved transportation networks and telecommunications.** Strengthened and simplified contract enforcement would support the spread of subcontracting, which would in turn multiply opportunities for financial, technological and information exchange between larger urban companies and smaller rural ones, and would ease access of non-metropolitan enterprises to urban markets. The numerous NGO and donor projects focusing on business development are in need of
evaluation, to scale up the approaches that deliver the best results. Other interventions that strengthen linkages between micro and small enterprises and larger firms would also be beneficial.
Chapter 1 INTRODUCTION

1.1. Why is the investment climate important?

The private sector – from farmers and micro-entrepreneurs to local manufacturing companies and multinationals – is at the heart of the development process through its investments in new ideas and facilities that strengthen the foundation of economic growth and prosperity. It provides jobs, tax revenues, and produces goods and services, improving living standards. In the context of a sound macroeconomy, a good investment climate provides a sound legal and regulatory framework for enterprises that promotes competition, strengthens governance and overcomes bureaucratic inefficiencies, and improves access to key financial and infrastructure services. Such an enabling environment for business stimulates faster growth and has a larger impact on poverty reduction.

For several years now, the World Bank, the Asian Development Bank and other development partners have been undertaking Investment Climate Assessments based on systematically gathered firm level survey data. The objectives of an Investment Climate Assessment (ICA) are to evaluate investment climate constraints faced by the private sector; assess the competitiveness of firms in a particular country and how they measure up against their neighbors and other comparator countries, and identify policies that will improve firm productivity and competitiveness. In 2003, the World Bank and the Bangladesh Enterprise Institute undertook the first ICA for Bangladesh (World Bank, 2003). This report provides an update to the earlier assessment based on Investment Climate Surveys conducted in Bangladesh between January and August, 2007 (Box 1).

The chapter proceeds to overview the extensions of the second ICA analysis beyond the areas of focus for the first ICA in 2003, and presents a detailed look at the growth drivers in Bangladesh in the past three years. Chapter 2 presents an overview of the private sector, and outlines the changes in investment climate over the past three years in the country. The chapter then delves into the detailed findings on each characteristic of the investment climate in Bangladesh, including electricity, finance, land, labor and gender issues, connectivity, innovation, government regulation and courts. Chapter 3 look sat the international competitiveness of Bangladesh, FDI and export promotion, as well as presents a comparison of the country’s standing within the region and internationally. Chapter 4 analyses location matters, sub-national constraints, and agglomeration, spill-over and location of non-farm activities. Chapter 5 presents the productivity and firm performance results. Chapter 6 concludes with available policy options on the key focus areas of investment climate conditions in the country.

1.2. What is new in the Second Bangladesh Investment Climate Assessment (ICA)?

The Second ICA takes a more comprehensive look at the business environment by extending beyond Dhaka and Chittagong, permitting locational issues to be explicitly addressed. The assessment includes 6 metropolitan areas of Bangladesh (Dhaka, Chittagong, Rajshahi, Khulna, Sylhet and Barisal) as well as the peri-urban areas surrounding the 6 cities, and a sample of small-towns and rural villages. These areas outside the 6 metropolitan centers are collectively referred to as “non-metropolitan” Bangladesh.

Non-farm economic activities in Bangladesh remain highly concentrated in Dhaka and Chittagong. In 2006 Dhaka alone had 81% of all non-farm enterprises employing 10 or more workers (10+) and accounted for 72% of national employment in 10+ enterprises (Figure 1.1).1 Chittagong followed with 12% of 10+ non-farm enterprises and 23% of 10+ employment. With the very high concentration of economic activities in two main metropolitan cities there is emerging evidence of mounting congestion costs (high housing costs and land prices, worsening traffic conditions and over-crowded infrastructure) in these areas. The urban primacy of Dhaka is already considerably higher than the “optimal primacy”

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1 These estimates are based on the 2006 Economic Census for Bangladesh (BBS, 2007). Some activities such as schools, NGOs and extra-territorial organizations are excluded in these estimates.
rate suggested by Henderson (2003) costing the country in terms of GDP growth.² The diseconomies of congestion have led to a decline in the number of enterprises in metropolitan areas. The number of enterprises declined at an annual rate of 2.7 percent between 2000 and 2006; in the same period, the average size of an enterprise in metropolitan areas increased from 67 to 77 workers, leaving total employment level unchanged. On the other hand, the number of 10+ enterprises in non-metropolitan areas has grown by 2% annually and employment in these enterprises has grown by 4% per year.

The expanded coverage also provides an assessment of the investment climate in non-metropolitan areas, and allows an analysis of the importance of rural-urban linkages and spillovers. Non-farm activities account for about 40 percent of total employment even in rural areas of Bangladesh. According to HIES 2005, about 62 percent of household income in rural areas is generated in the non-farm sector. The healthy growth of non-farm employment and income in the rural areas has been a key factor behind the substantial reduction in poverty in Bangladesh during 2000-2005 period. The continued expansion of non-farm activities will be essential for economic growth and poverty reduction in Bangladesh. Bangladesh’s population density is among the highest in the world with the exception of the city states. With the extensive margin of cultivation already exhausted and cropping intensity approaching its physical limit, agriculture is not able to offer additional employment opportunities. Much of the new entrants in the labor force, which amounts to about 1 million workers a year, would have to be absorbed in non-farm activities. Continued increase in non-farm employment and income will require growth in the size and productivity of existing enterprises and entry of new enterprises. A vibrant rural non-farm sector will be instrumental in ensuring a balanced pattern of development. Hence the importance of understanding the non-metropolitan investment climate.

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² The primacy rate is defined as the share of an urban center in total urban population of the country. At Bangladesh’s income and urbanization levels, Henderson’s estimate suggest an optimal primacy rate of 21 percent for Dhaka whereas its primacy rate stands at 32 percent. This excessive primacy of Dhaka is likely to cause at 2 percentage point loss in GDP growth (World Bank, 2007).
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The study takes a dynamic perspective to evaluate the impact of recent reforms. Bangladesh has undertaken several regulatory reforms in the past three years in the area of investment climate, whose impact is addressed via a dynamic comparative analysis of the 2003 and 2007 ICA surveys for metropolitan areas. An effective promotion of growth also involves shifting resources from less productive to more productive sectors, and the dynamic aspects of the study assess the extent to which efficient productivity shifts are occurring in the Bangladeshi economy.

The 2007 report also examined the investment climate in the services sector, which represent 52% of GDP. The 2003 ICA only included 10+ manufacturing firms. This update covers 10+ service sector firms in the 6 metropolitan areas as well non-metropolitan services. By providing a practical foundation for policy decisions, the assessment is designed to specifically help identify and prioritize areas of policy actions in support of a stronger private sector in rural, small town, peri-urban and urban areas of Bangladesh and give greater impetus to policy reforms leading to faster economic growth and poverty reduction.

Figure 1.1: Location of non-farm enterprises and employment in Bangladesh, 2006

Source: BBS, 2006 Economic Census

1.3. What has driven growth in Bangladesh?

Bangladesh has grown at a steady rate of around 6% in the past 5 years, poverty has fallen significantly, and the Millennium Development Goals (MDGs) have been on track with more success than in comparable countries (Annex 1 overviews the basic national economic indicators). This impressive performance has in a large part relied on enabling investment climate policies, in the area of mobile telecommunications, bank commercialization, customs and Chittagong port reforms, licensing streamlining, governance, and ongoing efforts in the judicial and tax areas. A recent World Bank study finds that Bangladesh could become a Middle Income Country (MIC) in the next decade or so by maintaining an annual growth rate of 7.5 percent, which would require significantly higher foreign and domestic investment rates, a more productive and competitive industrial base, further integration with the global economy, and unleashing the growth potential of areas beyond Dhaka.

Macroeconomic stability has been broadly maintained, high and rising inflation is the main concern. Numerous setbacks in the second quarter of FY2008, including major floods and a devastating cyclone, have exacerbated inflation fuelled by unfavorable international price developments.

Political stability and good governance have proven to be critical factors affecting the health of the Bangladeshi private sector – strong and credible institutions support investor confidence, foster

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regulatory compliance and enforcement, promote accountability, and facilitate public service delivery and public administration responsiveness to business needs. The IC surveys that this ICA draws on were undertaken in early- to mid-2007 soon after the transitional government took over, against the background of a political deadlock between the two major parties, the declaration of a state of emergency across the country, and the initiation of a number of major reforms including the high-profile anti-corruption initiative. Not surprisingly, political instability ranks high among the problems identified by enterprises in both metropolitan areas and in small-towns.

The external sector has been strengthened by continued robust performance of exports and remittances – further growth would rely on successful improvements in quality and safety standards, labor and management skills. Total exports have maintained an average annual growth rate of 14 percent over the last five years. Exports of Ready Made Garments (RMG) grew by 11.6 percent in FY2007, in spite of enhanced competition from other low-cost producers following the dismantling of the Agreement on Textiles and Clothing (ATC) on 1 January 2005 and months of intense political turmoil. Reported workers’ remittance has increased at an annual average rate of 17 percent over the last thirty years, boosting consumption, services, and construction in Bangladesh. Remittance inflows through formal channels in FY2007 were recorded at US$6 billion – almost 9 percent of GDP and half of gross merchandise exports.3 In the coming years, the export sector would remain competitive provided that issues of quality, labor skill, safety, and marketing / management skills continue to be addressed with a deliberate focus.

Private sector investment has been maintained at 16.4%, and FDI net flows are below potential at 1.3%. Higher investment levels domestically would depend on the ability of the financial system to fulfill its term transformation role; higher foreign capital flows will be attracted via further improvements in infrastructure, governance, and the regulatory environment. To reach East Asian growth rates of 7-8%, investment levels in Bangladesh would have to rise to 25-30%. FDI could help, as foreign-owned firms are a source of innovation spill-overs and perform significantly better than domestic firms in terms of labor productivity, TFP, and profit margins. Faster accumulation of physical and human capital is predicated on the ability of the financial sector to fund long-term private investment; a term transformation role which the financial system in Bangladesh has struggled with. Analysis has shown that a one percent increase in the ratio of private credit to GDP led to a 0.15 percentage point increase in the investment rate and a 0.22 percent increase in per capita income.4

Increases in competitiveness, both in domestic markets and vis-à-vis foreign producers, has been at the heart of stronger levels of growth. Greater competition is spurring innovation, as firms have started investing in technology and ICT, as well as creating pressures for improved labor skills, as the private sector strives for productivity improvements. Competition nationally and internationally has further potential to strengthen. 35% of firms consider the local market their main market, 36% operate in the national market, and 29% in international markets. Only 64.3% of firms reported that pressure from domestic competitors was important for their production costs, more so in Dhaka than outside. Competitive pressure is more important in services (72%), light engineering and other manufacturing, and competition was particularly stronger for small firms (74.9% versus 48.2% for large). Only garments firms considered foreign competition significantly relevant, a testimony to the relative isolation of Bangladeshi firms from foreign competition. Bangladesh also faces strong competition in the international market for other exports, such as shrimp. Although the volume of this trade has expanded, quality concerns have resulted in price discounting for Bangladeshi product and the value of trade has remained constant, in real terms.5 Pressure from informal competitors affected pricing decisions of 36.2% of wholesale and retail trade.

With sustained growth, the scarcity of certain resources (energy, finance, land, labor skills) has started to put a strain on the economy’s further growth and productivity gains, as factor markets

3 Migrant workers amount to about 6% of the labor force, mostly unskilled workers. Rushidan I. Rahman (2005).
5 There has been no real growth in the value of exports of fish and fisheries products from Bangladesh between 1994-2004. By comparison, China and Vietnam have both experience rapid growth in their trade. Between 1994-2004, exports from China and Vietnam increased by 7% and 20% annually, respectively (World Bank, 2008).
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have not risen up to the challenge of efficiently reallocating resources to the highest productivity entities within the economy. Growth in incomes are rapidly expanding demand for consumer goods and services, pharmaceuticals, light engineering products (electric, electronics and machinery), high-value and processed foods. Increasing numbers of women are entering the labor force which is likely to provide an additional stimulus for growth, as well as create additional challenges of economic adjustment. Most importantly, the economy is outgrowing its infrastructure base, and increases in electricity provision are urgently in order. Land in Dhaka and Chittagong has become scarce and expensive, and urban congestion costs are pushing companies into peri-urban areas. Yet these locations lack in critical services. Some larger cities also convey a promise of providing agglomeration economies, and these developments could strongly be encouraged via regulatory decentralization, effective local government, sub-national regulatory competition and improved connectivity.

Reallocation of resources to the MSME sector, a considerable source of productivity gains and employment growth, had been particularly poor. The majority of firms outside of metropolitan areas are MSMEs. Rural non-farm activities, the most promising force behind poverty reduction in the country, and the source of more than half of employment and incomes for the rural population, are fully reliant on those small enterprises. The services sector is primary composed of MSMEs. These small outfits are responsible for the bulk of employment growth in the country, and represent more than half of GDP. Further, productivity analysis indicates that smaller metropolitan firms are more productive than larger ones in many industries, which would suggest that, with efficient factor markets, resources should be reallocated their way. Yet small entrepreneurs are poorly skilled and educated, mostly informal, and most importantly, they are severely credit-rationed by the banks. Without resources to these more productive and poverty-reducing sectors, the Bangladesh economy shorts its productivity growth, income growth, and poverty reduction.

Table 1.1. Obstacles to business as perceived by the private sector (percent of firms rating the issue as major or severe)

<table>
<thead>
<tr>
<th>Firms in metropolitan areas</th>
<th>Firms in peri-urban, small town, village areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity (78.4%, higher for small firms)</td>
<td>Low demand for goods and services (41%)</td>
</tr>
<tr>
<td>Political instability (73.0%)</td>
<td>Inflation / economic stability (31%)</td>
</tr>
<tr>
<td>Governance (54.9%, higher for large firms)</td>
<td>Seasonal inaccessibility of roads (19%)</td>
</tr>
<tr>
<td>Access to land (47.1%, higher for small firms)</td>
<td>Cost of finance (19%)</td>
</tr>
<tr>
<td>Access to finance (42.5%, higher for small firms)</td>
<td>Electricity (17%)</td>
</tr>
</tbody>
</table>

Figure 1.2: Investment Climate Constraints

Source: Bangladesh ICS, 2007

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6 Bangladesh Bureau of Statistics.
7 “Although job creation has been important, poverty is reduced and incomes rise due to rising labor productivity. Still, the main determinant of labor market and poverty outcomes is endowment in […] education, land ownership, productive assets – for which capital is needed.” The World Bank. 2007. The Role of Employment and Earnings in Shared Growth. PREM Poverty Group.
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The structure of the economy had been moving away from agriculture, with industry becoming the second largest sector in the economy in 2001. The share of agriculture in GDP has dropped from 30 percent in 1990 to 20 percent in 2006 (Figure 1.3). The sector has experienced growth of 3.6% per annum of the past 10 years, but performance has been uneven. In the past 10 years, growth in the fisheries and livestock sectors has been stronger than growth in crop agriculture. Crop and horticulture GDP grew at an average annual rate of 3.1 percent between 1996/97 and 2005/06, in real terms, compared to growth rates of 4.2 percent for animal farming and 3.5 percent for fishing. Growth in the agricultural sector as a whole has slowed since 2001, with the exception of the animal farming subsector. The agricultural sector has been gradually transforming. The share of crop sector has declined from 65% in 1982/83 to 56% in 2005/06. Within the crop sector, the share of horticultural crops is gradually increasing. The contribution of the fisheries subsector to total agricultural GDP grew significantly from 15.6 percent in 1990/91 to 22.3 percent in 2005/06. Although paddy continues to dominate agricultural production, the production of high-value agricultural commodities has increased in response to growing domestic demand and prevailing export opportunities (World Bank, 2008). Exports of high-value agricultural products from Bangladesh more than doubled in real terms between 1985 and 2004, increasing from US$ 217 million in 1985 to US$ 495 million in 2004. Products of high-value agriculture accounted for about 5 percent of total export earnings for Bangladesh in 2004.

**Growth in the manufacturing sector has been robust at 11.4 percent in FY2007**, benefiting from better performance by pharmaceuticals, RMG, paper products, wooden products, non-metallic products, and the food and beverage industries. Manufacturing exports have also played a crucial role, though exports could be better diversified and FDI remains limited. Key barriers preventing further growth include weak innovation, labor skills mismatches, and for smaller firms, also access to land and finance costs. Aside from RMG, pharmaceuticals, ceramics and food products have also experienced strong growth over the last decade, although from a smaller base than RMG. Sectors with some potential (including for export diversification) such as textiles and leather are constrained in improving its competitiveness by protectionist policies. Annex 2 overviews dynamic and sluggish industries, looking for nuggets of growth, as well as the potential for services and IT sectors.

**Rising incomes in Bangladesh are spurring consumerism, which is further fuelled by urbanization and remittances.** Growth in services, which accounts for 52 percent of GDP, has been robust at 5.5 percent annualized real growth as opposed to 6.3 for manufacturing between 1996-2006. The sector ranges from bread-and-butter sectors such as wholesale and retail trade, hotels and restaurants, real estate, to higher value-added services such as transport, communication, business services and financial intermediation, not to forget the IT sector, which was found as the fastest-growing sector among SMEs. The sector is constrained by regulations poorly suited to it, as service firms tend to be small, credit-rationed, with few assets for collateral, and very visible sales captive to graft. Yet services have proven to be resilient to these difficult investment climate conditions, growing at a rapid pace, remaining competitive, and productive. There is a strong case for providing a more enabling environment for the services sector growth.

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8 “High-value agriculture” refers to fish, livestock products, fruits, spices, and vegetables that have a higher market value than traditional food grains.

9 Figures are in 2004 US dollars.

Chapter II  Characteristics of the investment climate

2.1. Overview of the private sector

Firms in metropolitan areas

The majority of metropolitan enterprises in Bangladesh are small, family run, sole proprietorships. Only 2.1% of companies in metropolitan areas are public limited firms, the balance composed of sole proprietorships or private limited companies. The private limited company form, which lends more protection to the owners and their property, is more prevalent in Dhaka and Chittagong, whereas sole proprietorships are much more frequent in other cities and rural areas, leaving owners exposed to the risks of loss of personal assets.\(^{11}\) This vulnerability is much more specific to smaller companies, as larger firms tend to get organized as limited companies.\(^{12}\) Manufacturing firms account for 68% of all metropolitan enterprises, followed by services (32%). Within manufacturing, garments and textiles firms are the largest in number (26% and 12%, respectively).

Enterprises are primarily male owned, and the vast majority are managed by their owners. Smaller metropolitan firms and those outside of Dhaka and Chittagong are at a disadvantage in terms of management education and experience. Metropolitan firms are predominantly closely held, with the largest shareholder holding 74% of shares on average (for large firms, this figure is lower at 55%). The vast majority of company owners are also founders. 55% of top managers own shares in the firm, and in 95% of the cases their share is greater than 20%. Ownership is least concentrated in garments and chemicals / pharmaceuticals. The vast majority (98.7%) of top managers are male. In the sample, less than 1% of firms are foreign owned, and less than half a percent are state-owned. Top managers on average have about 14 years of experience. Managing directors of larger firms and firms in Dhaka and Chittagong are vastly more educated (91% of large firms have a managing director with a graduate / college degree versus 34% of small ones, as do 51% (56%) of firms in Dhaka (Chittagong) versus, for example, 41% in Sylhet).

A significant share of metropolitan firms are located in an industrial estate, and most firms are members of the industry-specific business association. Overall, 16% of metropolitan firms are located in an industrial estate, with larger proportions for Chittagong (28%), Rajshahi (34%), Khulna (24%). Larger firms are more likely to be located in an industrial estate (18%) relative to small firms (13%). The textile companies have the largest share of any industry for their share of firms located in an industrial estate (18%), and services have the lowest. More than three-quarters (76.5%) of companies are members of a business association. The only firms who do not belong to an association are those in whose line of business a sufficiently relevant association does not exist. Most firms find membership very helpful with business support services, as they use the associations as a surrogate business school cum information / marketing / strategy source.

Firms in non-metropolitan areas

The vast majority of non-metropolitan non-farm enterprises are microenterprises employing fewer than 10 workers. On average these firms employed about 3 full-time equivalent (FTE) workers. Ninety-three percent had less than 5 workers, 5% employed between 5-10 FTE workers and only 2% had 10 or more workers. Most of the firms (98%) are sole proprietorships and owner managed. Slightly more than a third (34%) operate from their owner’s residence, but peri-urban enterprises are significantly less likely to be home-based (9%) compared to those in small-towns and villages (39%). Most of the workers in these businesses are the owner’s family members. About 28% of firms hired other workers. On average, 17% of the full time equivalent labor force was hired labor with peri-urban

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\(^{11}\) Public limited firms represent 2.1% of all firms in Dhaka and Chittagong, but 1.2% elsewhere. Private limited firms make up 40% of all firms in the two large cities, and only 13% in other metropolitan areas. Sole proprietorships, in contrast, represent only 11% of firms in Dhaka and Chittagong, and 19% outside those metropolitan areas.

\(^{12}\) 65% of small firms are sole proprietorships, and 79% of large firms are private limited.
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firms significantly more likely to hire workers than those in small-town and villages. 13 Most workers (80%) that are hired by non-metropolitan enterprises reside in the same village or mahalla where the enterprise is located. 16% came from outside the village/mahalla but from within the same district and only 4% from other districts.

Labor sub-contracting is growing practice among some non-metropolitan firms, particularly in the brick industry and in rice mills. Sixty six percent of firms in the brick industry reportedly hire labor via sub-contracting arrangements. A large fraction of firms that hired labor through sub-contracting (63%) reported that the main advantages were the greater flexibility afforded by sub-contracting, 19% felt that sub-contracting reduced search costs and 17% reported lower labor costs. Overall less than 1% of all non-metropolitan firms hire labor through sub-contracting.

The non-metropolitan enterprise landscape is dominated by retail and wholesale trade. Trading firms account for 43% of all non-metropolitan enterprises, followed by manufacturing (36%) and services (21%). Peri-urban areas have a smaller share of manufacturing firms (21%) as compared to small-town and villages (39%), but have more traders. The main manufacturing industries consist of manufacturing of apparel and leather (31% of manufacturing firms), followed by textiles (23%), furniture and other manufacturing (12%) and food and beverages (10%). Among trading firms, 91% are retail traders and only 7% are engaged in wholesale trade. Hotels and restaurants are the most common service enterprise, followed by health and social work and repairs of vehicles, personal and household goods. However, 75% of full-time equivalent employment is generated in 6 industries, including manufacturing of non-metallic minerals (primarily brick manufacturing), retail trade, textiles, food and beverage, wearing apparel, and hotel and restaurants (Figure 2.1). Retail trade accounts for the most full-time equivalent employment in villages (23%) and peri-urban areas (33%), while manufacturing of other non-metallic mineral products dominates in small-towns (45% of employment).

Figure 2.1: Non-metropolitan Employment

<table>
<thead>
<tr>
<th>Industry</th>
<th>Share of FTE employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-metallic minerals (bricks)</td>
<td>20</td>
</tr>
<tr>
<td>Retail trade</td>
<td>15</td>
</tr>
<tr>
<td>Textiles</td>
<td>10</td>
</tr>
<tr>
<td>Food and beverage</td>
<td>15</td>
</tr>
<tr>
<td>Wearing apparel</td>
<td>5</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>10</td>
</tr>
<tr>
<td>Furniture</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Bangladesh non-metropolitan ICS2007.

The firms are on average 10 years old. Twenty-two percent of firms could be classified as new entrants (2 years or less), but 30 percent have been in operation for more than 10 years. The majority of owners (88%) are male. Slightly less than half the owners (44%) had completed primary schooling and only a small minority (4%) had a university degree. Owners of larger enterprises tended to be more experienced and educated. 14 The vast majority of workers also have relatively low levels of formal education.15

A large proportion on non-metropolitan enterprises are informal businesses, only 40 percent are registered businesses. As is to be expected, fewer non-farm enterprises located in villages are registered (29%) as compared to those located in small-towns (40%) or peri-urban areas (57%). Interestingly, among non-registered peri-urban enterprises 66% claimed to be avoiding registration, compared to 33% who report it was not required. These proportions are reversed among non-registered firms in small-towns and villages (i.e. non-registered firms are more likely to claim registration is not required). Larger firms are more likely to be registered with 80% of firms with 10 or more FTE workers being registered compared to 36% of those with less than 10 workers.

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13 45% of peri-urban firms reported hiring workers compared to between 20-25% of small-town and village enterprises. Hired workers made up 26% of the workforce of peri-urban firms compared to an average of around 15% in other areas.

14 While only 23% of enterprises with less than 5 workers have owners with SSC or higher education, 63% of owners with 10-49 workers have an SSC or higher education.

15 23% had no education at all, 18% had some primary education, 41% had completed primary, 17% completed HSC and 2% had a university education.
2.2. Changes over the past three years (Table 2.1)

Security, licensing and customs have improved, as has mobile telecoms (but not fixed) coverage and import-export procedures. Labor regulations have virtually disappeared as an issue to business. Tax rates and administration have lost priority in the list of issues among other pressing obstacles. Financing, and especially land and labor skills, have drastically exacerbated as obstacles to business. Electricity and governance remain important obstacles, slightly worsening. R&D is increasing, albeit very slowly, and innovation via new equipment is falling. Due to different sample design in the 2002 and 2007 survey, the comparisons below involve only industries and cities used in the 2002 survey, and is therefore limited to Dhaka and Chittagong, and the manufacturing sector.  

**Bank financing** for investment has decreased from 26% to 25% of total corporate funds available for growth (see Annex 5). Spending on equipment fell from 2.1% of sales to 1.8%, and on real estate – from 1.2% to 0.4% of sales. Financing for working capital has also become more scarce – from 29% to 20%. More firms believe access to finance is a major or severe problem than three years ago – from 34.7% to 37%.  

**Access to land** has also worsened – 29.7% of firms considered it a problem in 2002, as opposed to 41.7% now. Land is one of the two issues which have experienced the most exacerbated rise in prominence as an investment climate obstacle. The loans requiring collateral have increased from 62% to 89% of all loans, and the collateral amount needed, per survey declarations, has increased from 79% of the loan value to 154%.  

The value lost due to **electrical shortages** has increased from 2.9% to 12.3% of sales. Now 76.6% of firms consider electricity a problem, up from 71.7% in 2002. The average wait for an electricity connection was 46 days, as compared to 60 days in 2002.  

Perception on business **licensing**, on the other hand, have improved – the share of firms perceiving this as a problem has decreased from 20.4% to 11.9%. **Taxation** has somewhat eased in the minds of the private sector, both in terms of level of tax rates (from 29.5% to 20.6%) and administration (from 41.3% to 31.1%). While the business sector has heightened its awareness as a result of the government anti-corruption efforts, during 2007 Bangladesh registered a remarkable improvement, jumping up over 15 ranks according to the governance indicators of Transparency International 2008.  

**Labor regulations** have further decreased in importance among the list of major problems for the business community – now only 4.6% of firms consider them an obstacle, down from 10.9% three years ago. **Labor skills** are the single most exacerbated problem in terms of the share of firms perceiving the issue as a severe or major obstacle – 29.1% of firms now struggle with low labor skills or a skill mismatch, as compared to 14.2% three years ago.  

**R&D spending** has increased as a share of sales from 0.2% to 0.7%, though it remains at a very low level. Firms do not innovate as much via new equipment as before (42.9% in 2002 versus 30.9% in 2007), and their innovation via new management and labor is much at the same level, so R&D becomes particularly important for increases in productivity, and funding scarcity for investment in new equipment becomes even more relevant as not only an obstacle to extensive growth, but to productivity increases as well. Customs and trade regulations have abated as a serious problem in Bangladesh – from 32.5% in 2002 to 13.8% now. The average time to clear exports through customs has decreased somewhat from 8.98 to 8.4 days, and to import – from 11.5 to 10.4 days.  

**Security, law and order** have seen a marked improvement in the past three years. Only 14.6% of firms consider crime and disorder a major or severe obstacle to business in 2007 as compared to 32.8% in 2002. Still, almost all large firms pay for security (97.4%) whereas only about two-thirds of small firms do so (68.2%). Costs of security payments and losses theft, robbery, vandalism or arson were low.  

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16 Differences in samples, such as the fact that the 2002 sample has a higher incidence of large firms, were eliminated via weighting the figures. However, this is an imperfect procedure as there are differences in the quality of the economic census between the two periods, which is used as a basis for the weighting.  

17 There is some weak evidence that non-bank financing might be somewhat making up for this trend, increasing from 1.1% to 1.6%, though the change is too small to be of economic significance.
Table 2.1
Inter-temporal Comparison of Metropolitan sample 2002-2007

<table>
<thead>
<tr>
<th></th>
<th>Bangladesh mean, 2002</th>
<th>Bangladesh mean, 2007</th>
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<tbody>
<tr>
<td><strong>FINANCE</strong></td>
<td></td>
<td></td>
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<tr>
<td>Bank finance for investment (%)</td>
<td>26.3%</td>
<td>25.3%</td>
<td>6.8 a</td>
</tr>
<tr>
<td>Non-bank financing for investment (including leasing)</td>
<td>1.1%</td>
<td>1.6%</td>
<td>1.8 c</td>
</tr>
<tr>
<td>Bank financing for working capital (%)</td>
<td>29.0%</td>
<td>20.0%</td>
<td>25.1 a</td>
</tr>
<tr>
<td>Access to and cost of financing a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>34.7%</td>
<td>37.0%</td>
<td>6.7 a</td>
</tr>
<tr>
<td>Collateral needed for a loan (% of loan)</td>
<td>79.3%</td>
<td>154.2%</td>
<td>3.5 a</td>
</tr>
<tr>
<td>Loans requiring collateral (%)</td>
<td>62.1%</td>
<td>89.1%</td>
<td>21.6 a</td>
</tr>
<tr>
<td>Access to land a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>29.7%</td>
<td>41.7%</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>ELECTRICITY</strong></td>
<td></td>
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<tr>
<td>Value lost to electrical outages (% of sales)</td>
<td>2.9%</td>
<td>12.3%</td>
<td>20.1 a</td>
</tr>
<tr>
<td>Electricity supply a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>71.7%</td>
<td>76.6%</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>GOVERNANCE</strong></td>
<td></td>
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<tr>
<td>Poor governance a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>50.0%</td>
<td>56.5%</td>
<td>2.1 b</td>
</tr>
<tr>
<td>Business licensing and permits (% major and severe)</td>
<td>20.4%</td>
<td>11.9%</td>
<td>6.0 a</td>
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<tr>
<td><strong>TAXATION</strong></td>
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<tr>
<td>Tax rates a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>29.5%</td>
<td>20.6%</td>
<td>8.3 a</td>
</tr>
<tr>
<td>Tax administration a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>41.3%</td>
<td>31.1%</td>
<td>9.7 a</td>
</tr>
<tr>
<td><strong>LABOR</strong></td>
<td></td>
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<tr>
<td>Labor regulations a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>10.9%</td>
<td>4.6%</td>
<td>6.5 a</td>
</tr>
<tr>
<td>Skills/education of workers a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>14.2%</td>
<td>29.1%</td>
<td>13.3 a</td>
</tr>
<tr>
<td>Firms offering formal training (%)</td>
<td>15.8%</td>
<td>18.7%</td>
<td>13.7 a</td>
</tr>
<tr>
<td><strong>INNOVATION</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spending on R&amp;D (% sales)</td>
<td>0.2%</td>
<td>0.7%</td>
<td>5.7 a</td>
</tr>
<tr>
<td>Percent of firms which chose to innovate via new equipment</td>
<td>42.9%</td>
<td>30.9%</td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>TRADE &amp; CUSTOMS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average time to clear direct exports through customs (days)</td>
<td>8.9</td>
<td>8.4</td>
<td>24.0 a</td>
</tr>
<tr>
<td>Average time to claim imports from customs (days)</td>
<td>11.5</td>
<td>10.4</td>
<td>20.6 a</td>
</tr>
<tr>
<td>Customs and trade regulations a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>32.5%</td>
<td>13.8%</td>
<td>16.4 a</td>
</tr>
<tr>
<td><strong>CRIME</strong></td>
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<td></td>
</tr>
<tr>
<td>Crime, theft and disorder a &quot;major or severe&quot; obstacle (% of firms)</td>
<td>32.8%</td>
<td>14.6%</td>
<td>14.9 a</td>
</tr>
</tbody>
</table>
2.3. Electricity persists as a major barrier for the business community

Electricity supply has struggled to keep up with demand spurred by solid economic growth. The private productive sector reports significant losses as a result of power scarcity. The issue is particularly detrimental to MSMEs who cannot afford generators. Manufacturing firms blame the low capacity utilization primarily on scarce power.\textsuperscript{18} Estimates put the cost of electricity shortages to Bangladesh at as much as 2 percentage points of annual GDP growth.

The electricity sector in Bangladesh is characterized by a severe shortfall in generation capacity. Per capita electricity generation in Bangladesh has been increasing over the years (from 143 KWh in 2004 to 155 in 2007, yet has remained among the lowest levels of power generated in the world. While overall capacity in the country amounts to 5,300 nameplate MW, useable capacity is only about 4,400MW, due to de-rating (the highest generation achieved so far has been 4,290 MW). On the other hand, peak demand consistently exceeds 5,000 MW, with the overall result of pervasive power cuts and surges. Estimate peak load shedding, in MW, doubled from 2004 to 2005, then doubled again in 2006; in 2007-08, some load management measures combined with renewed attention to operational and maintenance issues have helped some, and there has been some decline in load shedding over the course of the last year. Even so, even in low demand seasons, load shedding is usually not less than 300 MW, and during peak hours in the warmer months, is routinely 1,000 MW and higher. Power outages (and even more harmfully for business: power surges) are an important constraint on growth (78.4% of firms consider electricity a major or severe obstacle to business).

The sector is plagued by considerable shortcomings in transmission and distribution. Power generation in the country is dependent on 5 major power plants. Fault in any of the large power plants has a major impact on the entire grid. Less than half of households (and by some counts about one third) in Bangladesh has access to electricity.\textsuperscript{19} In rural areas, where grid-supplied power is largely absent, access is even more limited. Access is mostly rising in rural areas (from 19% to 31% in 2000 to 2005, as compared to an urban increase from 80% to 83% in the same period), with spotty quality and reliability of the service, and a heavy cost of expansion imposed on the national grid in terms of equipment overload and outages. The situation is particularly dire in the West Zone (Khulna, Rajshahi, Barisal).\textsuperscript{20}

The relationship between local electricity officials and companies is wrought with graft, as businesses vie to secure much needed power. New investment in the power sector has been hampered by rent-seeking, and poorly transparent bidding procedures, so there has been no substantive quality addition to the grid in the past five years.

Tariffs, set at below electricity cost, are rarely increased in Bangladesh. The last tariff hike in March 2007 (first one in four years), which increased urban electricity prices by 5%, leaving the ‘lifeline’ or first tariff block of 100 kWh unaltered, and thus did little to fundamentally improve sector finances. In fact, electricity has been getting cheaper in real terms.

Pervasive power outages rob the country of 2 percentage points of national growth. Virtually all firms experienced power outages (98% in metropolitan and 99% in non-metropolitan areas). Those very few who did not report outages were not connected to the public grid either because they relied fully on generators or did not require electricity (brick fields). On average each metropolitan firm faced 98.5 power outages a month, or more than three a day, for about an hour each. Services fared particularly badly with 119.5 incidences of power outages per month. Small firms were hard hit as well (103.5 times versus 86.1 for large firms). The total annual incidence of power outages comes to 1105 hours (comparable to the Doing Business estimate of 1443).

\textsuperscript{18} On average, firms only use 80% of their capacity. Metropolitan firms point to electricity as the major reason for capacity underutilization, followed by working capital financing shortages.

\textsuperscript{19} BBS reports that 44% of households had electricity in 2005, up from 31% in 2000, but effective access rates are lower.

\textsuperscript{20} Peak demand in the West Zone is about 600 MW, of which the region can only generate around 90 MW reliably, and a maximum of 200 MW. The national grid is unable to supply more than 200 MW of additional power to the West Zone.
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Problems with electricity supply are also a major concern for non-metropolitan enterprises and ranked among the top five major/severe constraints identified by non-metropolitan enterprises. 73% of non-metropolitan non-farm enterprises have an electricity connection, but connectivity varies considerably by location with the highest rates in peri-urban areas (88%), followed by small-towns (77%) and village enterprises (66%). Larger non-metropolitan enterprises (i.e. firms with 10 or more workers) are significantly more likely to identify electricity a major severe constraint compared to those with less than 10 workers (53% versus 17%) and manufacturing firms are affected disproportionately. 25% of enterprises without electricity are not connected because there is no supply in their location, 32% complained about high connection costs and a similar proportion had no need for electricity. 21

Among enterprises that are connected, power outages are universal (99% of connected enterprises in non-metropolitan areas reported outages). Reported hours of outages are higher in peri-urban areas (median annual outages of 728 hours) compared small-town and villages (both with median annual outages of 546 hours) and outages are particularly frequent in the winter months. While the duration of outages is shorter than in major cities, unlike their metropolitan counterparts few non-metropolitan firms have access to generators. Only 18% of peri-urban, 9% of village and 5% of small-town enterprises reported using power from a generator during outages.

**Firms in metropolitan areas estimate that they lost 11.7% of sales value due to electricity outages, up from 3.4% in 2002.** Losses in non-metropolitan areas are lower with firms reporting losses of 3% of their sales due to outages. The heavy reliance on generators in Bangladesh means that the reported losses seriously understate the true costs of the poorly performing electricity grid. Smaller firms were particularly vulnerable (losing 13.1% of sales value as compared to 8.4% for large firms), and were those in Dhaka (12.4% as opposed to 7.7% in Chittagong, for example). Services sales were less sensitive to electricity outages by the nature of the business. Sectors with critical reliance on power such as garments and chemicals / pharmaceuticals use generators, if they can afford them. Less successful industries with less access to investment cash were the hardest hit by their dependence on electricity, including textiles, leather, and light engineering.

**Power unreliability has caused a veritable boom in generator sales in the past three years.** The median firm owns a generator, though the median small firm does not (28.2% of small firms, 61.9% of medium firms and 91.4% of large firms own a generator). Over three quarters of garments and chemicals / pharmaceutical companies have one, though less than half in other industries do. Firms estimate they have to rely on their own generators for about 28% of the electricity consumed. Generators represent a considerable investment, at 5.3% of a firm’s total fixed assets at book value on average. The total power capacity of captive generation is reported to be around 2,000 MW, or about half of the public electricity production in the country. 22 In an industry with economies of scale, this is inefficient. In this survey, the average reported cost per kWh for electricity generation was Tk. 7.7 (net of set-up costs), which is above public grid prices of Tk. 3.5, and the Bangladesh Growth and Export Competitiveness Report (World Bank 2005) puts the cost even higher (at up to 2.5 times public prices). Smaller firms report even higher costs of Tk. 8.1. The majority of firms use diesel generators. Only very large companies are able to afford gas-fired generators.

**2.4. Finance: MF at world levels, long-term and MSME business financing remain challenges**

Bangladesh compares favorably with its peers in terms of domestic credit to the private sector, though long-term lending as well as lending to smaller firms and firms in the rural non-farm sector has remained inadequate. The Bangladesh financial system is dominated by the banking sector (at 90% of financial sector assets).23 Bold reforms during 2000-01 resulted in the declining importance

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21 Only 9% of the mahallas/villages surveyed as part of the non-metropolitan sample were not electrified. 25% of locations with electricity have only been electrified since 1995.

22 This study’s rough estimate is similar, assuming a power factor of 0.5. A lower bound to this estimate is provided by PWC which puts the total CPP capacity in 2005 at 600 MW. A quarter of the CPPs had capacity of 1-3 MW, and another quarter - 15-30MW. In addition, 324 diesel engines and 130 gas turbines had an average size of 455kW and 9340kW respectively.

23 Equity markets stand at 4% of GDP and insurance sector premiums are at 0.61 percent of GDP.
of nationalized banks (amounting to 25% of loans to the private sector as compared with 70% from private banks). \(^{24}\) Bank assets grew by 11 percent between 2000 and 2005, and bank credit - by 18 percent. The lion’s share of this growth has gone into consumer, not enterprise, lending, however. Further expansion of credit to smaller firms requires the adoption of modern risk-based lending methods – current lending instruments based on collateral (mostly land) are ill-suited to most firms in the country. These rigidities of the financial system cause inefficient reallocation of resources and reduce growth potential. Nearly half of metropolitan firms (47.1%) and 23% of non-metropolitan firms consider access to and cost of financing to be a major or severe obstacle to doing business. \(^{25}\) Although fewer firms in non-metropolitan areas reported facing major/severe constraints with financing, this should not be interpreted as an indicator that financing constraints are more severe for metropolitan firms. In general, across all indicators, fewer non-metropolitan entrepreneurs voiced complaints. However, as discussed in more detail below, access to finance for both working capital and investment purposes is major challenge for the non-metropolitan entrepreneurs, who are primarily owners of micro-enterprises.

Almost all metropolitan firms (over 95%) surveyed have a bank account, as compared to 9% in non-metropolitan areas. Larger non-metropolitan firms (those with 10 or more workers), however, are significantly more inclined to use bank services and 71% have bank accounts. At the time of the survey, 50.8% of metropolitan firms had at least one loan from a financial institution and 25.3% of the firms had an overdraft facility or line of credit from their bank. Larger metropolitan firms have much greater access to loans (73.1% versus 41.4%). Loans for metropolitan firms mostly come from private banks - state-owned banks have a larger role outside Dhaka and for specific government supported industries, such as leather and food processing. Whatever little financing is provided for metropolitan services, is entirely from private banks. Smaller metropolitan firms are eschewed by state banks if anything, more so than by private ones - 11.5%of small firms has a loan from a state-owned bank compared to 24.9% of large firms.

In non-metropolitan areas, only 6% of enterprises availed of formal finance. 3% had borrowed from banks (in the past 3 years) and 4% from NGOs/MFIs. Access to formal finance for larger non-metropolitan enterprises (those with 10 or more workers) is comparable to that of smaller metropolitan firms with 32% reporting having a bank loan and 3% with NGO/MFI loans. But formal finance for non-metropolitan microenterprises is extremely limited. A mere 2% of microenterprises had bank loans and slightly higher numbers received loans from NGOs/MFIs (4%). Firms that reported having bank loans were equally likely to have a loan from a private bank or a government commercial bank. Grameen bank and BRAC were the main sources of MFI/NGO finance and account for 59% and 41% of all NGO/MFI loans received, respectively. \(^{26}\)

Medium and long-term credit is scarce. In metropolitan areas, 69% of lending has a maturity of less than 3 years. A little less than half of the loans have maturity of 1 year. The average loan term for bank loans in non-metropolitan areas was 17 months, with 75% of loans with a maturity of 1 year. 70% of NGO/MFI loans also had a one year maturity. More than a third (38%) of non-metropolitan enterprises reported having access to supplier credit, but this is also very short term finance with 80% of firms reporting repayment periods of 3 weeks or less. As a result long term financing is typically procured through accumulated earnings, and firms tend to under-invest – we note a sharp decline in capital stock for metropolitan enterprises in key sectors of about 5% (9% in leather). \(^{27}\) Some companies roll over existing loans, which can be destabilizing to the financial system. Leverage is very low in Bangladesh by international standards – leverage in the metropolitan services sector is 19.7% (3.4% for services other than retail), among small firms – 27.5% (versus 37.4% for large firms), and is particularly low for

\(^{24}\) The poor condition of state banks is due to weak governance, weak management, operating weaknesses, including inadequate or nonexistent information technology, ineffective control systems, and antiquated credit and risk management.

\(^{25}\) Non-metropolitan firms were asked five questions regarding aspects of financing. This included the availability of formal financing sources, loan procedures, interest rates, collateral and unofficial payments. 23% of non-metropolitan entrepreneurs reported that one or more of these five aspects of financing was a major or severe constraint for their business.

\(^{26}\) Since some entrepreneurs borrowed from more than one.

\(^{27}\) As reported by WB Bangladesh Strategy for Sustained Growth 2007 [hereafter: BSSG].
firms outside Dhaka – the average firm in Sylhet is leveraged at 4%.\textsuperscript{28} For non-metropolitan firms, new investments are also predominantly financed from own savings (96% of new investments comes from internal financing sources). The low reliance on loan financing is reflected in the median leverage rates 0% for small enterprises and 14% for large enterprises.

**Credit information in the country is inadequate and unreliable so banks have to rely on collateral to provide security for the loans.** A credit information bureau (CIB) is operated by the central bank containing current loan information of all borrowers of financial institutions regulated by the Bangladesh Bank. However the system is not computerized, only contains information about current loans above Tk. 50,000 (and not the full banking history of the borrower) and does not have a unique identifier for borrowers. This reduces the effectiveness of the system particularly hurting smaller firms who cannot build up a reputation based credit score. It also hurts the banking industry because they cannot screen customers with poor banking history.

**Small firms are credit-rationed, so are landless firms.** As a result, most loans require collateral (91.4% of the metropolitan firms reported they needed collateral for their most recent loan and 80% of non-metropolitan firms applying for bank loans reported having to provide collateral). The collateral used is mostly land, to the tune of 148.1% of the value of the loan for metropolitan firms (median 140%).\textsuperscript{29} The average value of collateral required for non-metropolitan firms was 40% of the loan value. For every size, a significantly higher proportion of firms which own land have loans. For metropolitan firms, machinery is also used as collateral, typically in addition to land.\textsuperscript{30} The lack of a functional system of registered movable property other than for public limited companies is constraining the use of movable collateral.\textsuperscript{31} Accounts receivable are very infrequently used (3.1% of the cases). It was frequent that owners of metropolitan firms were also required to put up a personal asset security – the owner’s land and houses (45% of loans had that), in the event of lack (or insufficient value) of company assets for collateral. Personal assets were more frequently used in other manufacturing and services as well as in general for smaller firms. In non-metropolitan areas 83% of bank loans required a co-signer.

**NGO/MFI finance is slightly more accessible for non-metropolitan microenterprises, but borrowing from NGOs/MFIs is very costly and loan amounts are small.** 64% of small enterprises that received a loan (in the past three years) relied on microfinance/NGO loans as opposed to 10% of large enterprises.\textsuperscript{32} Enterprise borrowing from MFIs/NGOs had a median loan size of 10,000 Tk with an average annual interest rate of 15%. But firms that borrowed from MFIs/NGOs reported needing to have large compulsory savings (the median amount of savings was almost 20% of the loan size). Since interest for MFI/NGO loans is not applied on a declining basis, loans from these institutions end up being much costlier than bank loans.\textsuperscript{33} The higher cost of borrowing from MFIs/NGOs provides an explanation for the perceptions among many non-metropolitan entrepreneurs that interest rates are high.

**The narrow product mix offered by banks poorly matches client preferences.** Banks are unable to distinguish more creditworthy customers from its client base and offer them better products and conditions. Large and small firms faced very similar interest rates (13.1% versus 13.5% in metropolitan areas and 12.6% versus 13.7% in non-metropolitan areas). This compares very favorably with the 6.98%

\textsuperscript{28} We’ve used the widest definition of leverage here – total liabilities over total assets. The figures for bank loan over total assets are similar, since Bangladesh firms do not have very diversified liabilities.

\textsuperscript{29} 20% of the loans were financed with collateral greater than or equal to 200% and 5% required collateral more than 250%. 14% of the loans were approved with less than 100% collateral. Almost two-thirds of those were collateral free.

\textsuperscript{30} Just 6.7% of loans were approved with only machinery and equipment put up as collateral, emphasizing the importance that financial institutions attach to land.

\textsuperscript{31} The creation of security interests over movable assets is complex, lengthy, and relatively expensive. The priority of security interests over movable assets (that is, the public demonstration of the existence of such interests and the establishment of their priority) is unclear. Disclosure of security interests functions poorly. Enforcement is slow and expensive.

\textsuperscript{32} By comparison, 90% of borrowing of larger firms (with ten or more workers) comprised of bank loans.

\textsuperscript{33} The median loan size for bank loans obtained by non-metropolitan enterprises was Tk 930,000 at an average interest rate of 13%. Loan sizes varied considerably with small firms having median loans of Tk. 280,000 compared to a median loan of Tk 2.6 million for firms with 10 or more workers.
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deposit rate for commercial banks and 12.99% lending rate, with 7.14% inflation rate.\textsuperscript{34} Clearly, these low rates are only profitable for the banks given the collateral and other assurances. Enlarging the pool of customers to riskier clients will increase the break-even interest rate, but also the funding available for investment. The lack of price differentiation is one of the reasons for tight credit to smaller firms. Interest rates were markedly higher for other manufacturing and services, by a couple of percentage points.

**Banking innovation is lacking.** A lack of credit information on customers and an ineffective legal system for contract enforcement means that banks are not willing to lend without very secure collateral. The need for a more diverse product mix preferences is apparent from noting that only 19.1% of small metropolitan firms who did not apply for a loan did so because a loan was not needed (78.9% of large firms did not apply for a loan because they did not need it). A quarter of small firms found the procedures too complex, (only 1.2% of large firms did). Twice as many small firms had problems with the loan costs. 30.8% found the collateral high, the maturity short, or their chances of getting approval low, as opposed to 4.2% of large firms. In fact among small firms, high interest rates are rarely the main concern – hidden costs, in contrast, are estimated at 608% of loan value.\textsuperscript{35} Costs include complex documentation requirements, long waits, collateral requirements, difficulties in producing financial statements and business plans, and an intensive and complex application process requiring many meetings between borrowers and banks. Doing Business (2007) reports that a typical small business loan requires up to 29 steps, 9 meetings with the bank and over 50 different documents totaling 200 pages. Typical requirements for a loan is to get the financial statements audited (only 24% of small metropolitan firms and less than 1 percent of non-metropolitan firms do that routinely), register the collateral, hold 6-7 meetings with the bank. Small firms in particular find loan applications complex, collateral unattainable and loan approval unlikely. Smaller firms are less likely to have personal contacts in the banks and thus they are subject to more scrutiny.

**Micro-lending remains yet to be tailored to micro-enterprise needs.** In 2005, bank lending to both urban and rural MSMEs accounted for just 2 percent of total lending in 2005, though they produce a considerably more significant share of GDP, and represent one of the most effective means of sustainably eradicating poverty.\textsuperscript{36} Microfinance is slowly expanding into products more suitable for micro-enterprises (11% of lending),\textsuperscript{37} due to the pioneering efforts of BRAC, followed by other large microfinance institutions (such as ASA, Grameen, and PKSF). MSMEs do not seem excluded from financial markets due to poor financial performance – they have strong returns on capital and robust long-term profitability. Yet, lending requirements, including collateral, are not adapted to the business needs of this segment. The market size for loans to MSMEs is estimated to be nearly 400 billion taka, with 1 million potential clients (commensurate with a third of total outstanding bank loans). However, banks have not moved into this promising market, due to the considerable challenges they face with current regulatory environment and existing technologies: low-value transactions with high transaction costs (in the absence of technology improvements), limited formality (and therefore credit information), and sensitivity to loan delivery time. 75% of non-metropolitan firms report a need for additional financing, but only 3% applied for a formal loan to meet these financing needs. Among those that needed additional financing but did not apply, 35% claimed that they had fears about being able to make the payment and 25% reported that they did not want to be in debt. Despite citing high interest rates as a constraint, only 9% of small enterprises and 15% of large enterprises avoid applying for loans due to high interest rates.

\textsuperscript{34} 2006 data, to be comparable with the rates as requested in the survey.

\textsuperscript{35} Rural Finance – aurora.

\textsuperscript{36} National survey of enterprises and companies, ICG and MIDAS, for USAID, DFID, SDC and SIDA. Khandker (2003) shows that micro-finance benefits the poorest and has a sustained impact in reducing poverty. It also has positive spillover impact, reducing poverty at the village level. The effect is more pronounced in reducing extreme rather than mode. Grameen Bank (2004) found that nearly half the poor people who received credit escaped poverty, but only 4% of those without credit did. Some of the effect may be due to differences in education and landownership, but a large role remains for improving access to finance for creditworthy entrepreneurs.

\textsuperscript{37} Bangladesh Access to Rural Finance 2007.
2.5. Land: difficulties in property registration and management of serviced land

Serviced land is the single defining (or limiting) factor of new or expanding entrepreneurs. Almost half (47.1%) of metropolitan firms report access to land as a major or severe obstacle to business. The cost of land is considered among the top three obstacles to access to land by 92.5% for firms (and 99.2% of service firms). Also high are ranked issues of procuring the land (85.2%), and the availability of serviced land (66.6%), which are given much more weight than other issues such as disputed land ownership, for example (37.1%). Titling and registration of land are major problems. Land and building financing is very limited for longer-term commercial mortgages. Private sector growth is thus a major argument for promoting policies developing mortgage financing and industrial / special economic zones. Zoning restrictions were considered an obstacle by 11.5% of service firms. Doing Business 2008 ranks Bangladesh among the ten worst countries for registering property.

Smaller firms are cut off more severely from access to land – 94.7% consider land cost prohibitive (vs. 87.4% large) and 89% cannot procure land (vs. 75.8% large). Firms own on average 56.7% of the land they use and 48.4% of the buildings as well (and up to 83-84% in the case of textiles), a very high proportion by international standards. Outside of Dhaka and Chittagong, a higher proportion of firms own their land. The sluggishness of land markets causes inefficiency in resource distribution, as scarce land resources are not channeled to the most productive firms. For example, 18.3% of service firms attempted to buy land in the past 3 years, and virtually all (91%) were unsuccessful in doing so.

2.6. Labor: competitive labor, flexible labor rules, but low labor skills and training

Bangladesh’s manufacturing labor is cheap, and has been growing fast, but is of low productivity. Labor regulations are very liberal. Despite light labor regulations, structural barriers impair the efficiency of the labor market, including mismatches between economic performance and labor allocation, pressure from the public sector, skills shortages and mismatches. In September 2006 the government passed a new labor law granting limited workers’ association rights in the export-processing zones effective November 2006. More needs to be done to improve agricultural productivity, accommodate the shift from agriculture to other sectors, as well as address an overall rapidly growing labor force, gender issues, and skills and training.

The working age population is about 59% of total population, and the employment rate is 47% of total. The official unemployment is low at 1.5% (slightly higher for youth), but underemployment is high and rising – from 17 percent in 2000 to 38 percent in 2003. Employment has grown at a slightly higher rate than population (2.8%). Most workers still work in the informal sector, with agriculture as the major sector of employment. The informal sector accounts for 80 percent of employment; and for 76 percent of workers employed outside agriculture, forestry and fisheries. Overseas employment is also significant.

A quarter of metropolitan firms report an acute shortage of labor skills, across large and small firms alike (26.1% and 23.1%, respectively), and disproportionately so in Dhaka and certain successful industries such as garments (up to 37%). The high proportion of temporary workers (15%) does not help either, as it renders outside or on the job training unprofitable for most non-metropolitan employers. Generally, temporary employees remain unskilled as they receive very little training and skill

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38 The labor force of about 50 million has been adding about 2 million workers every year, due to a surge in youthful entrants as well as sharp increases in female participation. World Bank (2007c)
39 The cost of hiring is negligible. It is also relatively easy to fire a worker in Bangladesh, only four week’ notice is required and there is no legally mandated penalty for redundancy dismissal. Severance payments can be costly, though, amounting to 43 weeks of wages. The rigidity of hours worked is also quite low in Bangladesh.
40 However, these numbers should be treated with caution owing to lack of comparability across surveys and the fact that the measure of underemployment does not account for the willingness to work for more hours, as this question is not asked in the surveys.
41 Every year, about 250,000 Bangladeshis migrate abroad and about three million people of Bangladeshi origin are living and working abroad presently. The skill composition of workers overseas has become skewed towards semi-skilled and unskilled workers. This may be due to employers in foreign countries feeling that Bangladeshi workers lack appropriate skills.
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development. This scarcity in skills has translated into increases in real wages – by almost 30% in manufacturing despite sluggish growth in most sectors. Concerns over worker skills however is not a concern in non-metropolitan areas and virtually none of the enterprises complained about labor skills or regulations. Large, peri-urban manufacturing enterprises are significantly more likely to hire workers from other districts.

Real wages are increasing, and the wage gap between skilled and unskilled workers has risen in key growth industries. Labor is still very cheap in Bangladesh – total compensation for skilled and unskilled workers came up to 3% of sales, less for smaller firms and slightly higher for large firms. Average monthly earnings of non-farm workers by industry are provided in Annex 3. In non-metropolitan enterprises, wages are highest in the manufacturing sector (median monthly wage Tk 2,100), followed by trade (Tk 1750) and Services (Tk 1542). Labor unrest is somewhat of an issue in the country, with 11.1 days annually lost, on average, mostly due to political, not labor union, causes. The rate of unionized workers is low at 5.5% and more than half of the basic and plant level unions, of which there are 6000, are not affiliated with any National Centre. Benefits coverage is low, and only 17.8% of metropolitan workers have a formal labor contract.

Skills shortage and mismatch issues, perceptions for low skills of migrant workers, and inadequate levels of training can be linked to shortages in the country’s secondary and higher level education and vocational system. Of employees involved in production in metropolitan enterprises, 19.6% have no education (the proportion is almost half for leather and other manufacturing sectors, and is 30% for small firms versus 4% for large). Employees with secondary education or above constitute 25.4%, with 9% in leather and 80.6% in chemicals /pharmaceuticals. Small firms have 18.3% of employees with secondary education versus 33.5% for large firms. Training ‘in-house’ and in vocational schools are the predominant sources of training. While data from Bangladesh show that training has a positive impact on productivity and worker wages, only 16.2 percent of manufacturing establishments in Bangladesh provided their employees with in-service formal training in 2005/6. Training was negligible in metropolitan areas outside of Dhaka and Chittagong, and small metropolitan firms did not engage in any training. Garments, light engineering (electric / electronics / machinery), and pharmaceuticals / chemicals sectors provided relatively more training to their workers, while there was virtually no training in leather and other manufacturing. About 13 percent of firms report external training, sourced from vocational schools (31 percent) and private sector partner firms (26 percent). About 33% of the hired workers in non-metropolitan enterprises had received some training before joining the enterprises and 20% received on-the-job training from their employer.

2.7. Gender issues

A growing number of women in Bangladesh are participating in the labor force and an increasing number find jobs in manufacturing. Bangladesh’s labor force has been growing fairly rapidly - the working age population (15-64) has grown by about 18 million since the mid 1990s, and the labor force has grown by about 10 million over the same time period. A lot of this growth has come about due to increasing participation of women. While women’s participation rates are still very low (26 percent), over five million women have joined the labor force since 1996 (thus doubling the number of women in the labor force during this time period).

A relatively large proportion of women in manufacturing sets Bangladesh apart from most other countries in South Asia. In India 10.1% of women were employed in manufacturing, the comparable figures for Nepal and Pakistan are 3.9% and 14.6%, respectively (World Bank, 2008). The relatively high participation rates of women in manufacturing is due largely to the growth of the garments

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42 In 2005, there were exactly 6740 trade unions. Source: Department of Labor.
43 Only 16.2% of works are covered by medical insurance, 21.4% by accident insurance, 1.3% by pension benefits, 2.8% by free schooling / daycare, and 18.4% by free meals (higher in garments and particularly low in leather). Small firms offer much lower benefits, and benefits are virtually not offered outside of Dhaka-Chittagong.
industry. Nevertheless, services in Bangladesh employ the highest percentage of women (30%, as compared to agriculture with 25% and manufacturing with 15%).

The 2007 ICA results reveal that women constitute about 20% the labor force of non-farm enterprises in both metropolitan and non-metropolitan areas, and they constitute a large share of the labor force in garments and textile manufacturing. In metropolitan areas their participation rates are higher in large firms (44.5%) and garments (46.5%), although some sectors such as food, machinery, electrical, pharmaceuticals, and leather in metropolitan areas are completely devoid of female workers.45 In non-metropolitan areas, 26% of all women working in non-farm enterprises are employed in garments, 22% in textile, 14% in food processing, 11% in the manufacturing of non-metallic mineral products (primarily bricks) and the remaining in a wide range of other sectors. Seventy percent of all textile workers are women and they constitute 63% of all garments workers. In non-metropolitan areas women’s participation is highest in small towns (25%), followed by villages (23%), but quite limited in peri-urban areas (5%). Most women working in non-metropolitan enterprises are family workers, a mere 6% of all hired workers are women.

Female workers face considerable barriers in the labor market and there appears to be a high degree of gender segregation in the labor market. Women are poorly represented among technical and professional workers and women’s wages are 40 percent lower than their male counterparts (World Bank 2008). The gender gap in economic participation and opportunities in Bangladesh is comparable to most other South Asian countries, but trails Sri Lanka and the average of all low income countries (Figure 2.2). In Bangladesh, the average female worker in non-farm enterprises is less skilled and schooled than her male counterpart. In metropolitan enterprises, women constitute a very small share of skilled employees (only 8.2% of skilled workers in metropolitan firms are women), with the exception of garments where the female share of skilled workers is 19.5%. The education gap is also apparent in the labor force of non-metropolitan enterprises. 62% of male workers have a primary school or higher education as compared to 41% of women workers. Female garments workers are generally more educated women. In fact, 70% of women in the non-metropolitan garments industry had a primary school or higher education, compared to 38% of women in textiles. Women in non-metropolitan garments manufacturing enterprises were also on average more educated than the men working in these firms (70% of women with a primary or higher education versus 64% of men).

The rates of female entrepreneurship in metropolitan firms Bangladesh are comparable to those in Sri Lanka, for example, but are lower among rural non-farm enterprises. Women entrepreneurs owned 18% of all metropolitan manufacturing firms, 8% of metropolitan services sector firms and 12% of non-metropolitan firms. 95% of non-metropolitan women entrepreneurs are involved in manufacturing and about a third of all non-metropolitan manufacturing firms are headed by a woman. In non-metropolitan areas, women own 35% of all businesses that manufacture garments and other apparel, 34% of textile manufacturing firms, 17% of firms that manufacture tobacco products, and 6% of firms producing wood and wood products.

Non-metropolitan enterprises owned by women are smaller, younger, more likely to be informal and home-based. The majority of women owned enterprises (97%) are home-based compared to 25% owned by men. These enterprises are also younger and smaller with an average of 1 full time equivalent

45 No female workers in the median firm

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**Figure 2.2: Gender Gap Score: Economic Participation and Opportunity**

<table>
<thead>
<tr>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Low Income</td>
<td>0.65</td>
</tr>
<tr>
<td>All Countries</td>
<td>0.60</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.55</td>
</tr>
<tr>
<td>Nepal</td>
<td>0.45</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>0.40</td>
</tr>
<tr>
<td>India</td>
<td>0.35</td>
</tr>
<tr>
<td>Pakistan</td>
<td>0.30</td>
</tr>
</tbody>
</table>


*Note: One is the highest score, implying gender equality*
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worker compared to 3 workers in male owned firms.46 Only 4% of women owned enterprises have hired workers versus 18% of male owned firms. The majority of women owned non-farm enterprises are informal, only 2 of firms are registered compared to 42 percent for firms owned by men.

Women entrepreneurs are also less educated and more likely to be self-taught compared to male business owners. When asked how they had gained management and technical skills to run their business, more women entrepreneurs in non-metropolitan manufacturing reported being self-taught (70%) compared to men (44%). Interestingly though, a significantly higher proportion of women entrepreneurs reported gaining skills from formal education as compared to men (17% of women compared to 3% of men). 38 percent of women business owners had no education compared to 19 percent of male counterparts.47

Women non-metropolitan entrepreneurs report facing similar business obstacles as their male counterparts, but they perceive finance to be a significantly larger constraint than male owners. In general, women had fewer complaints with one exception; they are more likely to complain about the cost of finance. 29% of women entrepreneurs complained about the high cost of loans compared 19% of male owners.48 On the other hand, women were significantly less likely to complain about electricity and inflation. Only 2% of women entrepreneurs rated electricity as a major or severe constraint compared to 25% of male owned businesses.49

Not only do women entrepreneurs complain more about finance, but they also have significantly less access to enterprise finance. Fourteen percent of male manufacturing business owners in non-metropolitan areas had applied for a loan, but less than 1 percent of women owners had. Regression analysis of the probability of applying for bank and NGO finance indicates that even after controlling for firms characteristics and asset values, women owners are significantly less likely to have access to a bank loan or an NGO loan. Women entrepreneurs also have a more difficult time in accessing informal funds. 31% of women owners reported not being able to access any informal borrowing as opposed to 13% of male owners. And the amount they could borrow from informal sources is only 700 Tk (median) compared to 7000 Tk for men.

2.8. Connectivity

2.8.1. Market linkages

Low demand is perceived as the most serious obstacle to doing business in non-metropolitan areas. 41% of non-metropolitan enterprises rate low market demand as a major or severe constraint. Marketing issues have ranked high among the concerns of rural and small town entrepreneurs in other surveys of the rural investment climate. In Sri Lanka, Pakistan and Tanzania, low demand and problems with marketing also rank among the top 5 constraints identified by rural and small town entrepreneurs.50

Access to larger markets significantly influences enterprise perceptions of demand. The majority of non-metropolitan enterprises in Bangladesh sell their goods and services directly to consumers located within the same union/ward where they are located which largely limits the size of the markets for their products and services. Compared to enterprises that sell directly to consumers, enterprises that are able to sell to larger firms are less likely to complain about low demand. As seen in Table 2.2 small firms in trading and services are especially reliant on direct sales to consumers within the same village/mahalla. Smaller firms could tap into wider markets through sub-contracting arrangements, but these types of arrangements are few and far between in non-metropolitan Bangladesh (in fact less than 1

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46 Women owned enterprises are on average 6 years old compared to 10 years for firms owned by men. 30% are 2 years or less compared to 21% for male owned firms and 64% are less than 5 years, vs 43% for male owned firms.
47 45 percent of male owners had a primary school or higher education compared to 34 percent of female owners.
48 Difference is statistically significant at the 99% level (F(1, 49) = 7.9792, P = 0.0068)
49 While there are no statistically significant differences in terms of the proportion of manufacturing enterprises with electricity connections by gender, women owned businesses did report fewer outage hours per year (303 hours) than their male counterparts (584 hours).
50 In Sri Lanka 28% of businesses identified lack of market demand as a major/severe constraint. The comparable figures for Tanzania and Pakistan were 29% and 10%.
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% of non-metropolitan enterprises rely on sub-contracting arrangements). About 30% of metropolitan manufacturing firms had sub-contracting arrangements for input purchases, but only 1% of these firms purchased inputs from firms/distributors located in villages. Ten percent of firms made sales through sub-contracting, 3% of the firms/distributors sold to were located in villages.

Table 2.2 Non-metropolitan entities firms’ links with buyers and suppliers

<table>
<thead>
<tr>
<th>Share of firms selling their output to buyers in:</th>
<th>Manufacturing</th>
<th>Services</th>
<th>Trading</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own village/mahalla</td>
<td>&lt; 5 FTE workers</td>
<td>53%</td>
<td>5%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>64%</td>
<td>22%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>84%</td>
<td>27%</td>
</tr>
<tr>
<td>Same thana/upazilla but different union/ward</td>
<td>&lt; 5 FTE workers</td>
<td>15%</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>9%</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>24%</td>
<td>16%</td>
</tr>
<tr>
<td>Same thana/upazilla but different thana/upazilla</td>
<td>&lt; 5 FTE workers</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>10%</td>
<td>9%</td>
</tr>
<tr>
<td>Different district but same division</td>
<td>&lt; 5 FTE workers</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>Different division</td>
<td>&lt; 5 FTE workers</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Foreign countries</td>
<td>&lt; 5 FTE workers</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>&gt;5 FTE workers</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Bangladesh ICS, 2007

The few formal linkages observed in the IC survey were between metropolitan food processing firms and rural producers. Inter-locational linkages are also minimal – the vast majority of supplier linkages are within the same city. Food processing firms report contract farming arrangements for production of fruit pulp for juices and for aromatic rice. The vertical coordination between producers and purchasers becomes valuable for high-value agricultural products because of the high transaction costs and risks involved. In a production process where quality control is particularly important, contract farming enables processors to supply quality inputs, ensure adherence to codes of practice, and ultimately procure either raw materials for production or finished product that conform to specific requirements (World Bank, 2008). Despite contract farming’s numerous advantages, the enforceability of contracts remains a challenge in Bangladesh, where breach of contract is common among producers and purchasers alike.

Poor contract enforcement and low quality of production due to low technology and labor skills prevent more widespread sub-contracting among firms. Concerns over quality virtually prevent export-oriented metropolitan firms from sourcing inputs via subcontracting – the garments and pharmaceuticals industry, therefore, expand vertically into capital-intensive high-quality production instead of forging links with suppliers. A quarter of the firms who did not subcontract pointed to difficulties in ensuring quality control, while another 25% cited lack of predictability and reliability of supply. In spite of much larger numbers of micro and small firms, subcontracting predominantly occurs with larger firms (34.1% of subcontracting partners were micro-enterprises versus 53.8% medium and large firms). Even among subcontracting firms, financial and technical assistance is rare – only 20.4% of firms offered their subcontractor financial assistance, and an even lower percentage (16.8%) offered technical aid to improve quality and specifications.

Regression analysis confirms that the greater the distance to the nearest medium sized city (with a population of 100,000 or more) the higher the likelihood that a non-metropolitan manufacturer will identify low demand as a major/severe constraint. The opposite is true for non-metropolitan services, possibly reflecting that consumers in less well connected areas are more likely to rely on locally produced services. Manufacturing firms and traders located in communities where entrepreneurs

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51 Rural-urban linkages are minimal – only 5.7% of urban firms used subcontractors located in a village (among large firms, the figure is 0.5%, and aside from the food sector, where 34% of subcontracting arrangements were with village enterprises, incidence of rural-urban linkages are virtually nil).

52 Thus 99.1% of input subcontractors for Dhaka firms were located in Dhaka, and the numbers are 96.7% for Chittagong, 76.5% for Rajshahi, and 83.3% for Khulna.
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have better business networks (in terms of the number of suppliers and competitors know to the average business) are also significantly less likely to complain about low demand as a constraint.

**Many metropolitan and non-metropolitan enterprises would benefit from better market-related know-how and strengthened capacity for market research.** However, very few firms use any business services (such as marketing, accounting or technical support) and business service providers are relatively scarce in non-metropolitan areas. Even in metropolitan areas, less than 10% of firms would subcontract business services, in spite of virtually unanimous agreement on their affordability and quality. Being part of a business association could potentially help non-metropolitan firms improve their access to major markets. Indeed 22% of samity members (8% of all non-metropolitan entrepreneurs) reported receiving information about other markets from their samity. Samity members are significantly less likely to identify low demand as a major constraint (22% of members compared to 43% of non-members).

### 2.8.2. Telecommunications and IT

**Telecommunications are important for markets connectivity, mobile banking, as well as ICT and Internet development.** Research has found that with every 10 percent increase in mobile phone penetration, a country's GDP increases by 0.6 percent. 53 Bangladesh has performed poorly in terms of landline telecommunications, which has in turn slowed ITC and Internet penetration. The last two years, however, have seen spectacular growth in the mobile segment. Bangladesh has 0.79 fixed mainlines per 100 people, as compared with 36, 33, and 90 in India, Pakistan, and Sri Lanka, respectively. 54 The low penetration of landline telecommunications has impeded the development of the IT and software industries, and has deprived the country of ICT-induced governance improvements.

**According to a Wireless Intelligence report, Bangladesh is presently one of the top ten mobile phone growth markets in the Asia-Pacific region.** 55 In 2007, Bangladesh recorded unprecedented increases in new mobile subscribers at 31.8 million. 56 Grameen Telecom pioneered the Village Phone (VP) program, where villagers purchase a mobile phone and become the VP operator in the village. 57 This has considerably increased telecommunications coverage in rural areas. Increased competition in the cellular market segment with six mobile operators, including a public-owned mobile company, has led to significant growth and lower tariffs.

**Landline connectivity remains low, with resulting low penetration of broadband access.** Thirty-nine percent of non-metropolitan enterprises are located in communities with fixed-line phone connectivity, but only 2 percent of enterprises report owning fixed-line phones, which is extremely low by international standards. Ownership of fixed-line phones among non-metropolitan enterprises with 10 or more workers is slightly higher (20%). However mobile phone ownership is around 32%. 97% of non-metropolitan enterprises are located in an area with mobile phone connectivity. 86% of firms with ten or more workers own a mobile phone compared to 31% of those with less than 10 workers. Virtually none of the non-metropolitan enterprises report using faxes, email or the internet.

The average wait for a phone landline remains long at 93.9 days (median 45), and 74.8% of firms reported being asked for an informal payment. 58 Due to the available competition from mobile phones, as well as the existing inefficiencies in landline provision, many firms rely chiefly on mobile telephony. Less than half (39.7%) of firms use email to interact with clients and suppliers. Only 18.2% of small

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54 International Telecommunication Union 2006.
55 http://www.grameenphone.com/assets/annual_reports/pdf/Grameenphone_Annual_Report_06.pdf
56 Wireless Intelligence (Q4 2007 estimates).
57 Grameen Phones provides a commercial mobile service through local entrepreneurs, usually women, who own and operate cellular phones, charging fees from users. The initial outlay for a handset of around $ 350 is financed by Grameen Bank at 22% interest, which is unsubsidized and sustainable. User charges enable the entrepreneurs to pay back the loan, usually within a year. Grameen Phones started operations in Dhaka in 1997, and by March 2002 had covered 10,000 villages with an estimated 15 million people. The average annual income of phone ladies is estimated at $ 700 after covering all costs, more than double the per capita income.
58 A caution on small sample bias – only 4.93% applied for a telephone landline connection.
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firms (as compared to 87.3% of large firms) communicate electronically. Firms outside of Dhaka and Chittagong urban areas also use email less frequently. Email usage is most active in garments and chemicals / pharmaceuticals sectors (81.8% and 77.1% respectively), and least so in food, other manufacturing, and services, where only a quarter of firms use it, and particularly low in the leather sector (10.7%). Only 15.7% of firms use the Web, though the majority of businesses in garments and chemicals / pharmaceuticals do. These figures drop to 3.1% for leather firms and 5.9% for services. Only 2.2% of small firms use websites, as compared to 44.8% of large firms. Only 3.9% of workers regularly use a computer in their jobs (the number is somewhat higher in the chemicals / pharmaceuticals sector and for large firms). Only 14.1% of services firms have broadband connection, and those use it predominantly for communications, not transactions. The predominant reason reported for not using email or having a website was that clients and suppliers are not communicating electronically either (83%, versus 12.2% noting the cost of equipment).

2.8.3. Transport

The private sector has taken on a growing role in transport, bringing improvements in sector performance. Today state-owned transport companies carry less than 10% of passenger traffic and freight. The private sector is also engaged in road construction and maintenance. Domestic financing of road maintenance is inadequate, and regulatory procedures remain complex. The railway network in Bangladesh handles 10% of the country's freight traffic, and is facing increasing competition from a developing road network and high-capacity trucks. The system needs increased financial and operating efficiency. Competition is strong in inland water transport, where services are provided mainly by small private operators.

A third (30.3%) of metropolitan firms own their own transport, and 34.5% of shipments were made by own transport. Own transport use is especially high in the food and chemicals / pharmaceuticals sectors (more than half of firms and about three quarters of shipments used own transport). Smaller companies are more likely to outsource transportation, perhaps due to investment constraints (18% of firms and 21.2% of shipments were transported in-house as opposed to 46% and 53.1% for large firms, respectively). Losses of cargo in transit due to theft, breakage or spoilage was not significant – (0.1% and 0.7%, respectively, for all sales including export and domestic markets). Only 5.8% of firms reported considering transportation a major or severe obstacle to doing business (larger firms were more concerned).

Few non-metropolitan enterprises own their transport and most hire these services. Rickshaws are the most common form of transportation used by non-metropolitan enterprises (72% identified rickshaws as the most or second most common form of transportation used by their enterprise), followed by three wheelers (24%), bus (19%), cycle (10%), truck (6%) and motorboat (7%).

While few non-metropolitan enterprises complained about availability of transport facilities, a fairly sizeable fraction (19% of all non-metropolitan enterprises) identified inaccessibility of roads during certain seasons as a major/severe constraint. Not surprisingly village enterprises are more likely to complain about inaccessibility of roads (28% report this as a major/severe constraint) as well as road quality (14%) and road access (10%). Slightly more than a third of village enterprises are located in areas with internal paved roads (36%), compared to 69% in peri-urban areas and 44% in small towns. The median distance and travel times to the nearest district town/ upazilla headquarters (km) are also the longest for the village enterprises (8km and 30 minutes in villages, compared to 4km and 25 minutes in small towns and 2km and 10 minutes in peri-urban areas). The median cost of transporting one ton of goods from the nearest upazila headquarters ranged from 320 Tk in villages, to 290 Tk in small-towns and 270 Tk in Per-urban areas. Regression analysis indicates that firms located in areas with internal and external paved roads are significantly less likely to complain about inaccessibility of roads during certain seasons. But larger firms are more likely to complain.
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2.9. Much growth potential in innovation and investment in technology

Weak innovation and low investment in technology constrains productivity enhancements, governance and efficiency improvements. Firms perceive mainly local (not foreign) competitors as relevant. Even in garments, the leading export industry, local competitors are equally relevant as foreign ones. Only 7.8% of firms have internationally recognized quality certifications, with highest percentages in garments (23.4%) and chemicals / pharmaceuticals (22.2%). Only 3.8% of firms use technology licensed from foreign companies, with higher proportions in garments, light engineering, and chemicals / pharmaceuticals. R&D spending is very low at 0.7% of firm sales (nationally, R&D amounts to 0.03% of GDP, as compared to about 0.7% in countries such as China and India). On average, firms employ 1.4 R&D workers, but the median firm employs none. Garments and chemicals / pharmaceuticals employ significantly more R&D workers than others. Spending on IT is negligible at 0.05% of sales. Other measures of innovation confirm this trend. For example, companies and individuals in Bangladesh were granted fewer U.S. patents per capita than were those in other developing countries in East and South Asia. Similarly, basic research appears to be weaker in Bangladesh than in other countries in the region.59

In metropolitan areas, 29.7% of firms introduced new production technology, and 40.2% introduced new products or substantial upgrades of existing products. The methods of innovation employed included new equipment (31%), new management (28.5%), new products (22.9%), and new worker skills (16.7%). Most frequently, clients and suppliers are the source of innovation, though the business association and media is also a popular source. There was particularly little innovation in food and textiles, and a significant amount in chemicals / pharmaceuticals. Smaller firms innovate less overall, and those that do innovate via management change and new products rather than training and machinery, as the latter are less affordable.

New technology and technological change is of vital importance for the growth of the rural non-farm sector as well. In fact, important technical innovations, such as the introduction of Grameen’s Village Phone, has given rise to many new rural non-farm enterprises in the form of village phone providers in Bangladesh (Haggblade et al, 2007). Earlier the liberalization of tubewell imports and the liberalization of importation of diesel engines launched a revolution in two major rural non-farm activities.60

Despite, the importance of technology, only 3% of non-metropolitan enterprises reported improvements and/or technological innovations in their firms, with larger firms more likely to make improvements and technological innovations. Among firms that did upgrade technology or introduce innovations, 60% made product innovations, 4% made improvements to equipment and machinery, 2% reported improving workers’ skills through hiring and 2% made improvements in management. The majority of non-metropolitan enterprises (61%) rely on client firms as their primary source for acquiring marketing, product and new technology information. 11% reported their main source as equipment and machinery suppliers, 11% reported getting the information from other business and 9% through a parent company. A small proportion of enterprises also get information on new technologies through membership in business associations. 8% of non-metropolitan enterprises reported belonging to a samity, 11% belong to chamber of commerce and 11% to other business associations. About 11% of samity members reported getting information about new technologies from their samity.

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59 Authors from Bangladesh published fewer scientific articles per capita than did those from any of the comparator countries in East and South Asia except Indonesia. Doing Business 2007
60 Outside the dry season, when the engines were not used for irrigation, the diesel engines were used to power rice mills and thousands of seasonal hammer mills emerged. During the rainy season when the requirement for irrigation and rice milling had subsided the engines were also used to power small river boats transforming river transport in Bangladesh (Haggblade et al, 2007).
2.10. Government regulation and courts

2.10.1. Taxation: low but increasing collections

Taxation in Bangladesh is characterized by low collections, high complexity of rules and administrative hassle, and poor compliance, though very recent collection increases raise hopes. Bangladesh has a population of about 145 million but it has a registered tax base of only about 1.4 million people. The actual number of taxpayers is even lower – in 2004 it was 0.85 million (out of a registered tax base of 1.25 million at that time). It has become the norm in Bangladesh to pay minimum taxes or to avoid them altogether both because of lax enforcement of laws (tax defaulters are rarely investigated) and the hassle involved in dealing with tax authorities. Tax rules are complex which may offer opportunities for graft, and result in minimum tax payments with frequent underreporting of profit. Tax lawyers need to be hired to comply with regulations raising the costs of compliance.

It has been hard for the country to achieve its revenue collection targets, as a result of the small tax base and a very inefficient tax administration. The target for 2007/08 (438.50 billion taka), is already under-achieved to date, as was the 2006-7 target. Only 23% of total tax revenues in the fiscal year 2005-06 came from taxes on income and profit. Corporate income tax in Bangladesh is the highest in the region at 37.5%. Such high rates encourage tax evasion. Government revenues are therefore overly dependent on indirect taxes, particularly on tariffs and duties on imported goods. VAT collection has been relatively more successful although it is also plagued by avoidance and other issues. The tax-GDP ratio was only 8.7% in the 2005-06 fiscal year. In comparison the ratio in India was 16% (combined federal and state government). The majority of direct tax is collection from the corporate sector (65.5%), though by number corporates represent only 3% of tax payers. Even so, tax compliance and coverage among the corporate taxpayers is very poor. Among unlisted private limited companies, 25% pay 84% of the taxes collected (the bulk paid by foreign companies) and 13% did not pay any income tax. Among listed companies, 1.15% of companies pay 53.3% of taxes while the top 40% pay almost 100% of the tax collection. Tax rates have been subject to some recent simplifications, and further changes are planned. As a result, businesses report less trouble now than 5 years ago, but collection remains a problem.

Only 66.1% of metropolitan firms had to pay corporate tax in the past year (and as few as 18.5% in leather). The remaining 34% did not pay any taxes, for varying reasons, including tax exemptions and holidays, losses and tax avoidance. Tax exemptions are complex and numerous (one study found 106 exceptions to the flat corporate tax rate – see Annex 8). The firms under the tax holiday schemes are not newly established firms as the median firm enjoying such facilities was established in 1997. This is contrary to the official government position of granting tax holidays only to newly established industries. Strong lobbying and complicated regulations mean that companies continue to operate tax free long after their infancy.

The average corporate tax reported to have been paid amounted to 0.71% of sales, amounting to 8% of declared profits (median 1.47%). In the absence of tax evasion, this implies profit margins of 2%, an unrealistically low figure given the official tax rate of 40% of profits. The actual tax payments show significant usage of tax holidays and exemptions relative to declared profits. Taxes lost to revenue are even greater when one takes into account that profits are routinely under-reported. Only 4% of firms admitted to not fully declaring their profits for tax purposes. In contrast, we calculated that the average

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61 That suggests monthly revenue needs to average about 37 billion taka, but (for example) the August 2007 tax revenue was only 28.23 billion taka ($410 million). Value-added tax totaled 22.35 billion taka in July-August, the first two months of the fiscal year. Customs duty receipts were at 13.11 billion taka. Tax revenue was 371.74 billion taka in 2006/07, nearly 4.5 billion taka short of target.
63 Calculated using tax figures from Annual Financial Statement 2006-07 and GDP figure from World Development Indicators.
64 Sarker (2004) states that between 1990-91 and 1999-00, corporate income tax payers contributed 65.5% of total direct taxes on average although they formed only 3% of tax payers in 1999-00.
65 Sarker (2004) states that 1500 companies were under tax holiday schemes in 2004 and the total taxes foregone by the government amounted to about 10% of the total income tax collected that year.
66 Unweighted figures.
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firms paid only 16% tax on profits and the median firm paid only 7%. In sum, the vast majority of taxpayers, both individual and corporate, pay minimum taxes by hiding their real incomes, taking advantage of lax enforcement of tax laws. There has recently been debate on the abolishment of tax holiday facilities, which was primarily established to promote investment in specific sectors or areas and to attract foreign direct investment. However, it has been observed that this facility has been misused widely and the opportunity cost of the incentive has been high compared to the objective for which it was introduced. Developed country experience suggests that tax credits generate higher revenue compared to tax exemptions or allowances and this could be considered as an alternative measure.

The tax administration is a major barrier to the effective collection of tax revenues. The tax administration is cited by firms to be a greater problem than the tax rates (30% versus 19.8% of firms considered tax administration (versus rates), to be a major or severe obstacle to business. Firms in fast-growing industries were more sensitive, but small and large firms alike were affected. The ICS results also reveal that the top 10% of corporate tax payers in the survey contributed to 80.2% of the total corporate income tax collection while the top 5% contributed 64%.67 Fewer firms (22.8%) paid VAT in the past year, amounting to 2.24% of sales (the regulated rate stands at 15% of sales).68 These figures reveal the inefficiency of the tax administration in enforcing tax compliance among firms. Collections were markedly better with land tax and trade license fees.69

Tax issues do not loom large for non-metropolitan enterprises. In fact only 3% of non-metropolitan enterprises report paying taxes.55% of non-metropolitan firms with 10 or more workers and 2% with fewer than 10 workers reported paying taxes. Small non-metropolitan enterprises (less than 10 workers) that pay taxes, pay approximately 2% of their profit in taxes, while large enterprises that pay taxes, pay approximately 7% of their profit in taxes. Only 2% of large enterprises (0% small enterprise) perceive tax rates as a constraint and only 1% of large enterprises (0% small) report that taxation administration is a problem.

2.10.2. Red tape: basic licenses streamlined, other permits still difficult to obtain

About a third of companies (31.3%) consider economic and regulatory policy uncertainty a major or severe constraint to business. This opinion is particularly prevalent within services (40.6%) and construction / transport (50%), and is more problematic for small firms than large (33.1% versus 26%). Most businesses agree that officials’ interpretation of regulations is consistent (89%), which speaks, if not of the absence of graft, then of its relative predictability. Further, 56.9% of firms report that informal payments are known or predictable in advance.

Government is not perceived as unsupportive. 41% and 39% of firms believe the national and city corporation government to be supportive, and around 5% believe them to be unsupportive. What is more significant, though, is what belies those numbers – the vast majority of firms go not feel palpably the support of government. This begs the issue of the need for a more enabling slant in government policies. Smaller firms feel less supported by authorities than large ones (36% vs. 54% for national, and 37% vs. 46% for local government).

Procedural complexity and delays have eased for the most frequently used licenses – operating and import permits. Other licensing remains to be streamlined, but those are one-time permits which are used infrequently in the lifetime of the firm. Only 9.3% of firms consider licensing and permits to be a major or severe constraint to business. The wait for an operating license is 6 days, and for an import license – 10 days (median 7). Food, garments, and light engineering sectors perceive licensing and permits as more onerous 14-17% consider them to be a major or severe constraint to business. Food, garments, textile, and light engineering sectors top management also seem to spend more time with administrative requirements – 4.3%, 4.9%, 5.9%, 5.8% respectively, against an average

67 Unweighted figures.
68 53.9% of direct exporters / importers paid customs duties in the past year, amounting to 1.16% of sales. Municipal taxes were paid by 60.2% of firms, in the amount of 0.17% of sales.
69 Land taxes were paid by 91.9% of firms owning land, to the tune of 0.11% of sales. Trade license fees were suffered by 97% of firms, at 0.04% of sales. Compliance was higher among larger firms.
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of 3.8%. The figures overall for management time spent with administrative tasks might seem small in the context of the region; however, Bangladesh firms typically employ one or several full time facilitators to follow up on these issues. Senior management time spent dealing with administrative requirements is significantly more in Dhaka (about double) than on any other urban center (4% versus 2%). Some of this effect might be that most firms with any significant business are indeed located in Dhaka; however, these is clear corroborating evidence, perhaps exactly because of the larger number of businesses located in the city, that city administrators cannot cope well with the lines.

**Other licensing is onerous.** Doing Business 2008 points to 14 procedures and 252 days to obtain the permits and licenses to build a warehouse, at the cost of 751% of income per capita. It takes 28.5 days to obtain a construction permit (and the process is invariably accompanied by some side payments) The environment permit is a one-time license, with no subsequent enforcement. The environmental clearance process concluded that delays in the processing of environmental clearance certificates (ECCs) can be reduced by improving the capacity of inspectors and technical officers. The lack of trained staff, plus deficiencies in the legal framework and corrupt practices, also means that businesses often get clearance without putting in place an adequate environmental management system. In brief, well meaning businesses are harassed while the goal of environmental protection is often unrealized. The issues at the City Development Authority, the Rajdhani Unnayan Kartripakkha (RAJUK) are similar. Other reforms are underway and require continued implementation. The Board of Investment and Bangladesh Export Processing Zones Authority (BEPZA) introduced e-government processes to speed up and simplify procedures. These projects need to be sustained and replicated in other government agencies. Strict time limits in licensing combined with a silence-is-consent rule—where the authorization is automatically given after a specific period of time passes—can further reduce delays.

**Exit and entry of firms is not easy.** Entry takes a long time (74 days versus 33 in the region) and can cost a lot, due to registration fees, lawyer costs, and the trade / operating license.\(^{70}\) Corporate exit in Bangladesh costly (8% of firm value versus 6.3% in the region), though recovery rates are comparable (23.2% versus 24.9% in South Asia). It takes 4 years to go through bankruptcy proceedings, significantly lower than the 10 years it takes in India. But that is little comfort as global best practice is 0.4 years (Ireland) and regional best practice is 2 years (Sri Lanka). There have been less than 60 bankruptcy cases in Chittagong, Khulna and Bogra in the last 20 years, mainly due to the criminalization of the procedure. A manager who allows their company to go bankrupt is forbidden from entering into a corporate position for almost 7 years. As a result, there are many outfits which persist long after they have stopped to be profitable or even operational (97% of large firms remained large). There is little scope to grow – in Bangladesh, small firms remain small - 79% of firms never grow beyond 20 employees of size.\(^{71}\) In an economy which grows at 6-7% and where the industry mix is still very basic, with an enormous potential to develop, such figures, comparable with mature economies, are worrisome indicators of lack of dynamism. More disturbingly, this lack of dynamism is particularly acute outside of Dhaka and Chattagong, and for certain industries such as leather.

**Public services such as telephone or gas connection are very slow and accompanied by side payments.** For example, the average wait for an electricity connection was 50.3 days (median 30), nationwide.\(^{72}\) In non-metropolitan areas it takes an average of 83 days to get an electricity connection.\(^{73}\) Reported time to get a new connection ranged from a high of 93 days in villages, to 71 days in peri-urban areas and 51 days in villages. When communities were questioned, 80% reported that unofficial fees are needed to obtain an electricity connection. But among the 21 non-metropolitan firms that had obtained a new connection in the past two years only 1% reported paying such an issue. Gas connection is just as problematic as that for electricity. 2.82% of the firms applied for a gas connection. The average wait was 153 days. About 23% of non-metropolitan enterprises are located in communities with piped

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\(^{70}\) Doing Business 2008.

\(^{71}\) The economic census shows that of initially 890 small firms, 701 remained small (79%), 106 grew into medium firms (12%), and only 83 grew into big firms (9%). In contrast, of 153 medium firms, 107 grew large (70%), and of 342 initially large firms by employment, 97% remained large.

\(^{72}\) A caution on small sample bias – only 3.7% of firms applied for an electricity connection in the last two years.

\(^{73}\) Based on community level data
gas, but less than 1% of firms report using natural gas. The average wait for a phone landline remains long at 93.9 days (median 45), and 74.8% of firms reported being asked for an informal payment.\footnote{A caution on small sample bias – only 4.93\% applied for a telephone landline connection.}

Very few non-metropolitan firms have complaints about government agencies/ regulations/ licensing which is not very surprising given that most non-metropolitan enterprises are informal, micro-enterprises and not subject to many government rules, regulations and licensing requirements. Only 4\% of non-metropolitan enterprises reported having permits/licenses for operating their businesses. The most common types of licenses are environmental permits, fire permits, food and BSTI permits and milling permits. Overall only 3\% of the non-metropolitan enterprises reported having dealt with a government agency during the past 12 months for purposes other than registration/ obtaining a trade license. Firms were most likely to have dealt with a government agency for tax purposes or regarding environmental regulations. Firms that dealt with different government agencies reported that senior management had spent an average of 3.6 days in the past year dealing with requirements imposed by government regulations. Large firms (those with 50 or more workers) spend more time (6.5 days) dealing with government agencies.

2.10.3. Administrative red tape: the problem of weak institutions underscored

While Bangladesh improved considerably its ranking in the 2008 Transparency International Corruption Index (by 15 ranks), key institutions remain in need of strengthening. The issue has two equally important aspects - regulatory hassle and compliance problems. On the one hand, opaque, complex rules breed opportunities for hassle, to the point that graft does not even serve to speed up the outcome, as in a typical “speed-money” model, but is a mandatory element without which no outcome would be achieved at all. The heavy and complex red tape makes such graft possible, and even predictable, so businesses could plan ahead as they do for any other expense (57\% of firms think that firms know in advance the amount of the informal payment required to get things done). The effect on smaller firms is worse, as increases in business costs keep them out of formal markets. Generally, markets are less competitive in this environment and consumers, small business, and growth and employment creation are hurt.

The average firm receives annually 14.5 inspector visits (median 4), most frequently from the electricity and customs (over 3 visits annually on average). Sectors such as garments, leather, and transport / construction receive over 20 visits on average, while trade services firms receive 7. Large firms get 19 visits as opposed to the 10 visits to small firms. The number of inspections and visits by officials imposes a financial and non financial (i.e. time) cost on managers, and dampens firms’ performance. Regression analysis for Bangladesh shows that the number of inspections per employee has a significant negative correlation with investment and productivity.

Firms reported that 1\% of their sales go towards unofficial payments to get things done.\footnote{In addition to about 0.15\% for tax-related bribes and 1.4\% for obtaining a government contract. Given the anti-corruption campaign and massive jailings at the time of the survey, these figures are most certainly an understatement.} Three quarters of firms confirmed this in the case of a phone connection, 39\% for an electricity connection and 41\% for a water connection. More than half of firms paid a side payment to obtain an import license, 22\% for a construction permit, and 32\% for a trade / operating license. The situation is similar when the inspectors visit – the labor, tax and VAT inspections cost extra for a reported 18\%, 35\%, and 32\% of firms, respectively. It is commonly believed that the actual numbers are much higher. 78.8\% of firms agreed that it is common for establishments in their line of business to make side payments ‗to get things done with regard to customs, taxes, licenses and regulations.‘ Highest payment amounts were reported with the tax, VAT, and customs inspectorate, as well as electricity. Incidence of payments in garments and textiles is considerably higher (due to their wider exposure to exports and loans), and is lowest in services.

Smaller firms are less likely to pay experience regulatory hassle than larger ones (74.2\% to 88\%), as larger ones face more requirements. Controlling for that, though, small firms have a higher burden.
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In terms of water, electricity, and phone connections, small firms appear to pay sometimes more frequently than large ones: 92% vs. 13% for water, 46% vs. 32% for electricity, and 78% vs. 82% for phone. 76 The same is observed in the case of licensing – the gap between small and large firms is 1% vs. 47% for a construction permit, 43% vs. 54% for an import license, 28% vs. 39% for an operating license. The pattern is confirmed with inspection visits – 17% vs. 24% for labor inspections, 33% vs. 38% for tax inspections, 29% vs. 37% for VAT inspections. As with small firms, services sector firms face less requirements (and therefore lower graft incidence) overall, though side payment incidence per administrative procedure seems to be higher than average, especially for phone, operating licenses, VAT, and taxes.

The vast majority of non-metropolitan enterprises do not perceive corruption to be a significant constraint for their business. Among firms that dealt with government agencies (3% of all non-metropolitan enterprises) for purposes other than registration in the year preceding the survey, only 6 percent claimed that unofficial payments/gifts were expected or requested during their dealing with government agencies. Among those that reported unofficial payments, the median value of the payment made was Tk 1500 although they increased with firm size. Median payments ranged from Tk 200 for firms with less than 5 workers to Tk 3000 for firms with 50 plus workers. About 5% of enterprises dealing with government regarding tax related issues reported unofficial payments, as did 8% of those dealing with environmental regulations and 16% of those that dealt with government on issues related to food hygiene. 27% of non-metropolitan enterprises had renewed registration/trade licenses and 1% of these firms reported paying a side payment. While corruption appears to have less of an impact on non-metropolitan enterprises it should be mentioned that the ICA survey was conducted during a time of the anti-corruption drive by the caretaker government which may also have affected the responses.

2.10.4. Enforcing contracts is difficult, but courts catching up with business needs.

A well-functioning legal and judicial system is critical to create effective checks and balances and to help enforce contracts and settle disputes. Bangladesh's justice sector suffers from many of the weaknesses common in developing countries. While the Constitution and laws are generally sound, the justice system is subject to excessive delays and is perceived by many as not impartial. The higher courts perform better, however, and the Supreme Court has remained a relative island of integrity, showing its willingness to stand up to governments. General dissatisfaction with courts is high in Bangladesh. 71.5% disagree that the court system is fair, impartial and uncorrupt; 83.1% disagree it is quick; 76.4% disagree it is affordable; and 45.6% disagree it is able to enforce its decisions. Those figures were considerably stronger in Chittagong than Dhaka.

As a result, very few firms use courts, due to costs and time involved – only 1.8% of firms used courts in the past 3 years. Small firms use courts less than large, predictably. However, once a case goes to the court, it tends to be resolved, and enforcement of business cases is strong in the country. It takes on average 43.7 weeks for a court case to come to a judgment, and 8.1 further weeks for enforcement.

About a fifth (18%) of firms think that the functioning of courts on business matters is a major or very severe obstacle to business. Most companies use informal mechanisms to enforce agreements, or avoid an agreement. Doing Business 2008 ranked the country as one of the worst 5 countries to enforce contracts, mainly due to the delays involved. Other countries in the region also perform poorly on contract enforcement indicators. For example, trade credit extended could well be several years overdue without any court process being initiated. Further consequences include refusal to sell on credit to any but long-term clients, very little outsourcing and subcontracting, inefficient supply chains. The resources wasted to either avoid the need to contract or supplant courts by informal enforcement stunt growth, especially among SMEs.

The majority of non-metropolitan enterprises have had little experience of dealing with the court system. When asked whether the court systems are fair, impartial and uncorrupted 58% of entrepreneurs said that they had no experience. Of the remaining firms, 35% said they didn’t know, 34% 76 A word of caution - data is based only on the few companies in the sample who actually obtained the connection recently.
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said they disagreed or strongly disagreed and 31% agreed or strongly agreed. Only 10% of non-metropolitan entrepreneurs were of the opinion that the courts are quick, 6% believed they are affordable and 14% felt that courts are able to enforce their decisions.

Despite their lack of experience with the legal system, when asked about contract enforcement issues, non-metropolitan firms are quite optimistic. 53% of enterprises agreed or strongly agreed that a contract would protect them from being cheated by others. Only a small minority (3%) disagreed that a contract offered protection from being cheated while 44% reported that they either did not know or had no experience to respond to the question. Interestingly, confidence in contracts increased sharply with firm size. Among firms with 10 or more workers, 86% reported they believed that a contract would offer them protection from being cheated and only 7% disagreed or strongly disagreed. When asked if they agreed with the statement that the legal system would uphold their contract and property rights in a business dispute, 49% of firms with less than 10 workers and 86% of those with 10 or more workers agree or strongly agreed with the statement.

Courts are slowly waking up to business needs, the money loan court also has become more effective. The Money Loan Court Act of 2003 set up a special court to deal exclusively with default loans exceeding 5 lakhs, prescribed time limits for granting judgments and imposed restrictions on appeals. Second, major reforms in the Civil Procedure Code were made in 2003. The reforms facilitated different forms of case management, including introduction of court-annexed mediation and enforcement of pretrial procedures in pilot courts to weed out frivolous lawsuits. These efforts have resulted in an increased number of out-of-court settlements and in quicker disposal of court cases. In 2006 Bangladesh launched pilots to speed contract enforcement in Dhaka. Ongoing reforms are tackling the backlog of pending cases, lack of modern case management, weak court administration, and poor transparency and accountability. Further, and so far on paper, the lower courts have become independent. Upper courts have the community’s good faith.
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Chapter III. International competitiveness

3.1. FDI

Investment climate constraints are particularly relevant to the country’s attractiveness to foreign investment. FDI is very low in Bangladesh, by international comparisons, at 1.3% (net flows). For locations to take advantage of opportunities in the international market, they need good infrastructure and a sound regulatory environment. The interaction of openness and sound investment climate creates a good environment for investment and production. This is at least partially related to the structural problems in the business environment as well as unfavorable governance perceptions. The lack of FDI has meant that Bangladesh has missed out on positive technology spillover that it usually provides. FDI has picked up recently in extractive industries (coal and gas), telecommunications and energy production, but is still lacking in manufacturing, where the productivity gains from FDI are higher. Studies have found that Bangladeshi firms with any level of foreign ownership are 10 percent more productive on average than firms that are wholly domestically-owned. This report finds even stronger results – foreign ownership adds 80% to TFP.

Bangladesh derives a substantial comparative advantage from its low wage base and liberal labor laws, which should allow for increased domestic and foreign direct investment. Further incentives for FDI include few restrictions on foreign ownership of business, easy registration, attractiveness to selected natural-resource-based industries; and a steadily expanding domestic market for industries like pharmaceuticals and white goods. Factors affecting negatively the FDI decision include physical infrastructure and communication, openness and low tariff structure, literacy rates / labor skills, revenue-raising skills of the Bangladesh government and complex tax code subject to unpredictable changes.

3.2. Promoting exports

The past decade’s boom in exports – with earnings in 2003/04 of $7.6 billion, about three times the level of 1991/92 – has boosted significantly national growth. To make the most of its export opportunities on a changing international playing field, Bangladesh needs to relax further the trade regime, invest in infrastructure, technology and skills, streamline policies, and improve quality and safety standards. Trade liberalization and the resulting increase in export orientation have contributed to the growth acceleration since the early 1990s. After several years of reform hiatus, steady progress has been made on trade liberalization since 2002. Over the period FY02-07, the average customs duty has been lowered from 21.0 to 14.9 percent, the top customs duty rate from 37.5 to 25 percent, and the number of non-zero customs duties from four to three. This progress, however, was partly offset by an increase in the use of other protective tariffs (para tariffs), which now account for about 40 percent of total protection, compared to only 12 percent in the mid-1990s. Even so, the total nominal protection fell from 29.4 percent in FY02 to 26.5 in FY06, and further to 24.3 percent in FY07. The reduction in nominal protection was accompanied by a 90 percent cut in the number of quantitative restrictions (QRs), including virtual elimination of trade related ones in the FY06 budget. The removal of the longstanding ban on a wide range of textile imports in the FY06 budget was particularly significant. Despite the declining trend, average nominal protection in Bangladesh is the highest in the region and among the highest in the world. Bottlenecks are also created due to weaknesses in governance, transport, and finance. Bangladesh’s export orientation compares unfavorably with other Asian economies, and its export base is heavily concentrated in the garments sector, where the extent of the anti-export bias is much lower.

In metropolitan areas, 18.9% of firms export and 27.5% import directly, nationwide. Exports are considerably higher in garments, and somewhat higher in chemicals / pharmaceuticals, and non-existent in services. There is very little import / export outside of Dhaka / Chittagong, and for small firms (3%

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77 Dollar and al (2004) find that measures of international integration, the probability of a foreign-invested firm or the firm being an exporter, are closely related to the quality of the investment climate and the lack of barriers.


79 Administrative Barriers Study, FIAS.
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Small firms export directly versus 57% large, and 6% import versus 67%). Nationwide, metropolitan firms on average sell domestically 77.9% of production, with 17.3% directly exported and a further 4.8% exported indirectly. The majority of inputs are also procured domestically (68.7%), with 16.7% and 14.6% imported directly and indirectly, respectively. Of 2520 non-metropolitan firms surveyed as part of the non-metropolitan ICA only 4 reported making any exports in the past 5 years and 10 firms report importing raw materials or goods for resale. From these statistics, the Bangladesh economy does not appear well integrated into international trade, with the exception of a few export-oriented industries dominated by large firms in Dhaka and Chittagong.

On average, it took 8.4 days to clear imports through customs (median 5), and the longest times reported in the experience of firms were on average 15.5 days (median 10). For imports, average times were 10.2 days (median 7), and longest was 18.8 days (median 15). Smaller firms had an easier time with customs, importing for 7 versus 11 days, and exporting for 5 versus 9 days. 11.4% of firms only reported customs and trade regulations to be a major or severe obstacle to business. 7 documents are required for export (as compared with the regional 8.1 average), but 4.8 in OECD. It takes 33 days to exports, down from 35, and compared to 34 regionally and 11 in OECD. Cost is down from $902 per container to $844 (regionally $1,236) and $811 for OECD. The situation is similar for imports – documents needed are 10, down from 16 and compared to 13 regionally and 6 for OECD. The time decreased from 57 to 41 days, as compared with 42 regionally and 12 for OECD. The cost is down by about $150 to $1,248 per container, compared with $1,495 regionally and $883 for OECD. Other countries in the region have forged reforms in the area as well. Bangladeshi firms use import/export support mechanisms quite heavily, and in general are content with the costs and delays those mechanisms impose (Table 3.1).

**Table 3.1. Usage, cost, and delays of export / import support mechanisms**

<table>
<thead>
<tr>
<th>Export / import support mechanism</th>
<th>% firms using</th>
<th>cost high -% agree</th>
<th>delays high - % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customs duty drawback (direct exporters and importers only)</td>
<td>40.9%</td>
<td>13.0%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Duty exemption on imported inputs (direct importers only)</td>
<td>61.9%</td>
<td>11.5%</td>
<td>16.6%</td>
</tr>
<tr>
<td>Indirect tax (incl VAT) refunds</td>
<td>28.2%</td>
<td>18.7%</td>
<td>15.1%</td>
</tr>
<tr>
<td>Bonded warehouse (direct exporters or importers only)</td>
<td>54.9%</td>
<td>24.2%</td>
<td>20.1%</td>
</tr>
<tr>
<td>Export Processing Zone (direct exporters only)</td>
<td>6.1%</td>
<td>9.2%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Profit tax exemption / tax holidays</td>
<td>30.9%</td>
<td>9.1%</td>
<td>12.7%</td>
</tr>
<tr>
<td>Export credit facility (direct exporters only)</td>
<td>66.0%</td>
<td>14.1%</td>
<td>14.7%</td>
</tr>
<tr>
<td>Export credit guarantee (direct exporters only)</td>
<td>43.7%</td>
<td>13.8%</td>
<td>17.4%</td>
</tr>
</tbody>
</table>

*Source: Bangladesh ICS, 2007*

Industry-specific barriers to international competitiveness include import restrictions and incentives which favor import substitution, uneven benefits favoring specific export sectors, and weak quality and standards enforcement. For instance, protection for domestic textile manufacturers raises exporters’ costs and the time to deliver. Shoemakers and ceramics manufacturers alike - because they sell their products at home as well as abroad - are denied the bonded facilities that RMG firms use for duty-free imports. The compensating duty-drawback mechanism involves refund delays. Shrimp growers and their employees are both hurt by weak enforcement of the labor and environmental standards that such exports must meet in international markets. The “open sky policy” for air cargo needs to be made effective in order to attract international cargo carriers to land in Dhaka in order to lift fresh vegetable cargo for European markets which are now being supplied in limited amounts, partly due to a lack of air cargo space. The escalating tariff structure sets lower duties on imports of raw materials and intermediaries and higher ones on processed products, favoring domestic producers without spurring them, through competition, to higher levels of efficiency.

India and Sri Lanka allowed electronic submission of customs declarations cutting time for trading by 7 days each. Pakistan continued the expansion of its online declaration systems to other parts of the country. Doing Business 2008.
Considerable improvement has been achieved in the operation of Chittagong port, which handles 85% of the country’s trade. Bangladesh’s two gateway ports, Chittagong and Mongla, have been plagued by poor management and labor problems, resulted in a major export bottlenecks, and were in need of modernization and upgrading to sustain the country’s comparative advantage for export. The first Bangladesh Investment Climate Assessment (2002) found that the Port handles 100-105 lifts per berth a day, well below the productivity standard of 230 lifts per day as recommended by UNCTAD. Ship turnaround time was five to six days, compared to one day for more efficient ports. The main problems facing Chittagong Port include long and complex procedures; lack of sufficient manpower; lack of coordination between customs and port authority, and lack of accountability of officers and employees of customs and the port. These have led to irregularities and given rise to rent-seeking behavior. These inefficiencies directly hurt business, growth and employment.81

Recent reforms and the government anti-corruption drive, however, are yielding results. Following handover of Chittagong Container Terminal (CCT) to a private operator, there have been noticeable improvements in overall handling operations. Port efficiency has increased by 30 percent while the cost of doing business in the port has decreased by 40 percent. A recent Transparency International Report82 found that with the reduction of such complexities, there has been a reduction in expenses by Tk.30 million. A one-stop service incorporating shipping agents, freight forwards, customs, C&F agents and banks has ensured document clearance within twenty minutes. The New Mooring Container Terminal commenced partial operations in September 2006. The unloading time from ships has come down to 12 hours, and the turn-around time of ships has decreased to 3-4 days.

3.3. Bangladesh within the region and comparable countries

Metropolitan enterprises

The internationally comparative Doing Business data points to strong advantages of Bangladesh in labor regulations, and disadvantages in registering property and enforcing contracts. The data from the ICA survey points, in more detail, to advantages of Bangladesh in comparison to other countries in terms of labor regulations, customs and import/export procedures, crime, mobile telephones, micro-finance for individuals, and licensing, and disadvantages in courts / contract enforcement, access to land / property registration, labor skills / training, electricity, governance, access to finance (and micro-business loans), innovation /IT, and tax administration. Within the region, relative to world (Brazil, China, Indonesia, South Africa, Turkey, and Vietnam), South Asia countries do badly in electricity, access to finance, corruption, and labor skills. Annex 4 provides the detailed findings, while only the key messages are highlighted below.

81 The waits at the port can also be costly to firms. For Bangladesh, regression analysis controlling for industry and firm characteristics suggests that each day that exports are delayed in customs is associated with a 0.3 percentage point reduction in investment and a 0.2 percentage point reduction in sales and employment growth. It is estimated that Bangladesh’s garment exports could earn 30% more if inefficiencies at the port of Chittagong were resolved (Asian Development Bank 2003, “Technical Assistance to the People’s Republic of Bangladesh for Preparing the Chittagong Port Trade Facilitation Project.” Project 36105. Manila).

82 Mahmud, T. and J. Rossette. “Problems and Potentials of Chittagong Port: A Follow-up Diagnostic Study”. Transparency International Bangladesh. 2007. The report also finds that while the open transaction of bribery has declined to some extent and some irregularities and indiscipline have diminished, bribes continue to be exchanged through agents outside the port and customs offices.
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**Access to finance is tight.** More than 40% of firms nationwide agree that access to finance is a major or severe obstacle to business, a higher percentage than the average for low and lower-income countries, and highest in the region after Pakistan. In spite of the nation’s leading position world-wide in micro-finance outreach for individuals and especially women, micro-business and SME lending has been slow to develop. Bank financing in Bangladesh is the lowest in the region, but for Pakistan. As a result, firms in Bangladesh need to use internal savings to finance investment - internal sources fund 70% of firm investment in Bangladesh, as opposed to lower shares in the region). The situation is similar for working capital. **This leads to underinvestment and lower employment and production growth. SMEs suffer most.**

**Access to land is a major factor restricting entry of new firms into the market, and limiting competition.** Serviced land in Bangladesh is hard to find, and prohibitively expensive, especially for small firms. This problem is by far more severe in Bangladesh than in any other comparator country. Property registration in the country is one of the ten longest and most expensive such procedures in the world.

**Electricity shortages remain a critical barrier to private sector growth and a source of major expense to firms,** as producers attempt to correct the failures of state provision of electricity via private sector means – small generators servicing each plant. The gap between electricity provision and national needs has not shown signs of decreasing, despite some promising initial steps in reform. Bangladeshi firms lose more value to electricity outages and surges than any other comparator country in the region. The number of days when electrical outages occur is triple that of any other country, evidencing severe shortcomings in generation capacity, transmission, and distribution of power. **The country has been shown to lose on average 2% of national growth due to power sector problems.**

**Weak institutions result in regulatory uncertainty, the proliferation of red tape and administrative complexity, causing informality, and repudiating FDI.** As regulatory hassle increases, and compliance decreases, the very aspects entrusted to rules and regulations to guard (such as clean environment) are lost. Government budgets soar without achieving national priorities which the administration was entrusted to serve.
Labor regulations in Bangladesh are some of the most liberal among low income countries and the comparator countries in this study, and only slightly less enabling than on average labor regulations in lower-middle income countries. Bangladeshi labor costs are some of the lowest internationally, adding to the country’s competitive advantage in exports, and bringing in a significant share of remittances. However, employee skills are low, and poorly matched to the economy’s needs, which is considered by business as one of the major obstacles to productivity growth of the private sector. Training rates (16.2%) are lower than both low and lower-middle income country levels (26.5% and 42.2%), though comparable with South Asia levels (15.9%). Most firms cannot afford in-house training, and high shares of temporary workers employed do not make matters easier.

Innovation and assimilation of foreign technology could help with higher productivity growth; however Bangladeshi firms have some of the lowest levels of ISO certification ownership, and do not exhibit particularly high rates of new technology and product introduction and upgrades. Opening up to foreign competition will spur more innovation. Use of IT is also low in the country – web and email penetration among the private sector is at half of the level of comparator countries, and barely at the level of the average low income country, much below lower-middle income countries and the South Asia average. Electronic communication shortfalls are due to the poor performance and capacity constraints of landline telecommunications, which has impeded the development of the IT and software industries, and has deprived the country of ICT-induced governance improvements.

On the positive side, the last two years have seen a spectacular growth in the mobile telecoms segment, driven by private investment and policy liberalization.

Licensing, customs and import/export procedures have seen certain recent improvements. Time to export/import is comparable to low, but not lower-middle income, countries, though it has seen recent improvements as Chittagong Port has drastically overhauled its operations, easing international trade. Average tariffs remain high for the country, reducing competitiveness, sustaining industries with poor productivity, and raising the cost of doing business. Security, law and order have seen a marked improvement in the past three years. Dhaka is a leader in crime abatement.

Enforcing contracts is slower in Bangladesh than in almost any other country in the world, but courts are catching up with business needs. 18% of firms treat courts as a major obstacle, as opposed to less than 4% in comparator countries.
countries. Case delays are longer than all but one comparator countries, and almost double the level of delays in low-income countries. Enforcement is much better. Recent reforms have embarked on the long road to contract enforcement improvements. The new Money Loan Court speeded loan collections. Major reforms in the Civil Procedure Code facilitated case management, increased out-of-court settlements and speeded disposal of court cases. Pilots to speed contract enforcement were launched in Dhaka, to tackle the backlog of pending cases, strengthen court administration, and improve transparency and accountability. Lower courts independence was strengthened.

**Non-metropolitan Enterprises**

**How does the investment climate in non-metropolitan areas in Bangladesh compare internationally?** The investment climate for non-metropolitan enterprises can only be benchmarked with that of a small handful of countries for which comparable data exists. Unlike the IC assessments of larger urban manufacturing firms, surveys of the IC for non-farm enterprises in rural areas and small towns are a relatively recent phenomenon, commencing with a series of pilots undertaken by the World Bank since 2003. Nevertheless, the limited data that do exist are useful for making international comparisons. For a detailed description of how the different benchmarking indices are computed refer to Annex 4.

**Rural-urban connectivity/regional economic integration**

Non-metropolitan enterprises in Bangladesh operate in an environment of relatively good connectivity between rural and urban areas. For obvious reasons, peri-urban areas have the best connectivity, followed by small-towns and villages. Compared to Pakistan and Sri Lanka, countries with the most comparable data, non-metropolitan enterprises in Bangladesh are better connected. High mobile phone connectivity, proximity to markets and railways contribute significantly to Bangladesh’s favorable ranking. In fact, Bangladesh is second only to Nicaragua in terms of mobile phone connectivity (in peri-urban areas average mobile phone connectivity exceeds the average in Nicaragua) and significantly outperforms the comparator countries in terms of the proximity of markets (time taken by the main means of transport to the main market). The average time to the main market in Bangladesh is less than 40 minutes, compared to 90 minutes in Nicaragua. Although mobile phone connectivity is relatively good, Bangladesh is almost at the bottom of the rankings in terms of fixed-line phone connection and only marginally better than Tanzania where 3 percent of households had fixed-line phones in areas surveyed. 4% of non-metropolitan households in Bangladesh had a fixed line phone. Bangladesh ranks in the middle of the 5 countries in terms of the costs of public transportation to the nearest city. Average transport costs appear to be considerably higher than costs in Sri Lanka and Pakistan.

**Access to infrastructure services and service delivery**

While quality of electricity supply and roads are bottlenecks for non-metropolitan enterprises in Bangladesh, overall infrastructure services and delivery are comparable with most of the

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83 Rural investment climate surveys have been conducted in Sri Lanka, Tanzania, Nicaragua, Pakistan, Benin, Indonesia and Ethiopia. The 2003 National Private Sector Survey of Enterprises in Bangladesh conducted by International Consulting Group with MIDAS and HB Consultants Ltd did collect information on the overall investment climate facing firms in non-metropolitan areas, however the data are not strictly comparable with those that are used to construct the benchmarking indicators.

84 The rural investment climate surveys for Sri Lanka and Pakistan included small-towns as well as villages. In this regards it is comparable to Bangladesh.
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comparator countries, and far superior to Tanzania. Within non-metropolitan Bangladesh, infrastructure services and service delivery are the best in peri-urban areas, followed by small towns. Villages have the least favorable environment. Infrastructure services and service delivery in small-towns and villages in Bangladesh lag behind comparable areas in Pakistan but are better than conditions in Sri Lanka. Rates of electricity connections (70%) are comparable to other countries and much higher than Tanzania, however the availability of electricity is a real concern given the frequent blackouts. In this regards Bangladesh ranks at the bottom of the five countries. On the other hand, Bangladesh has the best access to protected water sources. Internal road quality is significantly better than Sri Lanka, but Pakistan performs better on this measure.

Availability of business development services

The absence of business development services in non-metropolitan areas of Bangladesh is striking, with the exception of small towns. In fact, non-metropolitan areas as a whole rank lower on this indicator than any of the comparator countries. The availability of business development services in small towns is comparable to Nicaragua, but the virtual absence in peri-urban areas is surprising. One of the reasons may be that peri-urban firms have abundant access to these services in neighboring metropolitan areas, so the low performance on this indicator does not necessarily imply these firms are at a disadvantage.

Figure 3.1: International Benchmarking of the Non-Metropolitan Investment Climate in Bangladesh


Governance

Non-metropolitan enterprises in Bangladesh face a favorable environment in terms of governance and its ranking is on par with most of the comparator countries. Governance is accessed on the
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basis of general policy and institutional constraints, unofficial fees required for service delivery, unofficial payments demanded when dealing with government agencies, predictability of laws, the application of the rule of laws, conflict resolution systems and contract enforcement. Of the different aspects considered, infrastructure service delivery and the issuing of various licenses/permits are areas where improvements would contribute positively to the business environment.

**Human Capital**

Despite relatively low levels of education amongst non-metropolitan entrepreneurs, Bangladesh ranks relatively favorably in terms of human capital when compared with comparator countries. Only Sri Lanka ranks higher than Bangladesh and not by much.

**Financial Services**

Compared to Sri Lanka and Pakistan, non-metropolitan areas in Bangladesh lag behind in terms of the level of financial intermediation available. The index provides a measure of the level of development of financial services. Financial intermediation is considered to be more mature if there are a greater number of formal financial institutions, there are more financial services available and the share of enterprises that want to borrow money is large. Compared to Sri Lanka, access to financial institutions and insurance is low. The access to loans is significantly lower than Sri Lanka and Pakistan, but comparable to rates in Tanzania and Nicaragua.

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85 Loans from government banks, commercial banks and NGO/microfinance have been considered as formal sources of finance in Bangladesh.
Chapter IV   Location matters

4.1. Sub-national constraints

Metropolitan areas

Bangladesh is urbanizing at a rapid pace, from a very low level as it is still a predominantly rural country. Yet, projections for Dhaka predict a population of 23 million by 2015, placing it among the highest agglomerations in the world. Urbanization is concentrated in the four largest cities – Dhaka, Chittagong, Rajshahi, and Khulna, which have more than quintupled in size since 1970. Some further 300 urban areas, in contrast, account for only 4% of the urban population. Urban concentration implies benefits from economies of scale and agglomeration, thick labor markets, better access to suppliers, customers, and infrastructure, higher quality of public goods and services, transport cost savings, economic transformation with large cities leading manufacturing / industrial representation, co-location of business and financial services boost firm level performance. Dhaka and Chittagong have over seven times the national representation of employment in garments and machinery. However, excessive urban concentration also causes high prices for land and housing, high commuting costs and segmented labor markets, congestion and pollution, and bottlenecks in infrastructure and service provision. Dhaka is increasingly characterized by large slums, poor housing, excessively high land prices, traffic congestion, water shortages, poor sanitation and drainage, irregular electric supply, unplanned construction, increasing air pollution and poor urban governance. These in turn increase production costs and translate into lower welfare and overall economic performance.86

Bangladesh urban concentration is above the optimal.87 Much of manufacturing activity in Bangladesh is located in the largest cities due to centralized allocation of local public expenditures, insufficient investment in interregional transport and telecommunications, centralized responsibility for urban and regional development, and failures of national land development markets. With limited local fiscal autonomy, land developers and local governments cannot develop alternate locations and spread development across the urban hierarchy. As a result, the manufacturing sector has made disparate contributions to regional development, from as low as 2 percent of GDP in parts of northern Bangladesh to a high of 40 percent in the Gazipur district.88 The distorted urban system translates into lost opportunities for economic growth, of an estimated value of 2 percentage points.89 The capital city Dhaka and its adjacent districts Gazipur and Narayanganj, and the main port city, Chittagong, have emerged as the two growth poles in the country, dominating both the urbanization process and economic growth, due to their infrastructure, skilled workers, a network of complementary firms that provide backward and forward linkages, and a critical mass of consumers.

Infrastructure presents a particular constraint to industrial development in the country. The five districts in Bangladesh where manufacturing accounts for more than 25 percent of district GDP have an infrastructure endowment more than three times that of the districts where the manufacturing-GDP ratio is below 5 percent. In addition to supporting business development, infrastructure aids migration across regions, counteracting inequality and lowering the urban / rural as well as east / west gaps in both household characteristics and returns to those characteristics.90 Yet the public sector has been slow in providing services and infrastructure outside a few select urban areas (one success case where higher concentration of private sector activity in Gazipur successfully applied pressure to government for infrastructure and public services provision, see Annex 8).

Dhaka was rated overwhelmingly as the best city to do business, mainly by the entrepreneurs located there. Barisal was the worst, as assessed objectively, as well as by its own citizens. Land

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86 Somik Lall, Presentation.
87 Somik Lall calculated the primacy ratio of Bangladesh at 32 percent, 11 percentage points higher than its optimal value.
89 Somik Lall estimates.
90 Shilpi (2007).
availability was a binding determinant for selecting location. Objective investment climate indicators tracked closely these subjective locational preferences of firms. The best city in terms of general business environment was Dhaka with 64% of firms preferring it to any other location for business, while Chittagong was second best with 18%. 91% of firms located in Dhaka thought Dhaka had the best environment while 80% of firms located in Chittagong thought Chittagong had the best environment. 39% of respondents thought Barisal had the worst business environment. 47% of firms located in Barisal thought Barisal had the worst environment. Only 3.3% cited Chittagong as having the worst business environment, lower than Dhaka at 11%. The top two factors in determining these locational choices were the availability of infrastructure, as well as access to customers and suppliers. Important factors working against locating in a specific city were access to land, and crime. Three quarters of firms reported that the reason for their location, independent of preference, was the availability of land – the location of the owner’s land holdings determined, rather than feasibility analysis or business factors, the choice of city for the majority of firms. Floods (regular and major) were found to have a stronger effect in particular areas, especially Sylhet and Barisal.91

Dhaka (and other major cities) will continue to attract rapid population growth unless other urban centers become viable investment decisions, via institutional reform, provision of serviced land, enhancement of own source revenues, as well as investments in inter regional infrastructure to de-concentrate standardized manufacturing. In turning to ask why industrial activities are disproportionately located in the largest cities, it is useful to consider factors that influence business location decisions. In a recent survey of empirical evidence of firm location decision across sub national regions in developing countries, the following factors have been identified as being important (Lall, Venables, and Redding 2005). These are (1) Quality and cost of complementary utility services, including electricity, water and telecommunication; (2) market access as a function of the size of the region that can be reached given existing transport infrastructure, (3) agglomeration economies as measured by the presence of firms in own industry and of firms in related—e.g., buying or supplying—industries, (4) labor and other regulations; (5) access to serviced land.

If Bangladesh adopted Bogra’s regulations on starting a business and dealing with licenses, Khulna’s rules on contract enforcement, Chittagong’s trade practices and Dhaka’s bankruptcy regulations, its ranking would go up from 88th to 62nd.92 The lack of access to finance, for example, from “no problem” to “major problem” (an increase of the value from 0 to 3), increases the probability of locating in Dhaka to 29%, and lowers the probabilities in the other cities, respectively, to 25%, 11%, 9%, 19%, and 6%, respectively, for Chittagong, Rajshahi, Khulna, Sylhet and Barisal. Labor skill shortages also increase the likelihood of firms locating in Dhaka as opposed to other cities. Tighter access to land, on the other hand, seems to push firms away from Dhaka, and into cities like Chittagong and Sylhet / Barisal. Regulations, business conditions, as well as public services and basic well-being indicators such as health and education, affect considerably the choice of location for businesses, and can be used as levers to control urbanization and agglomeration, as well as sub-national inequality outcomes.

Location has also a strong effect on poverty, and poverty is highest in districts outside Dhaka, with a few exceptions. The location effects are partly explained by availability of infrastructure, connectivity with local and national markets, and increased penetration of microfinance. Recent trends show a decreasing poverty differences between Dhaka and areas neighboring Dhaka district; however, differences in poverty remain large between Dhaka and large areas in the west and southwest of the country where almost no poverty reduction has occurred in recent years.93

The country does not have a comprehensive policy on urbanization and urban poverty. There are between 16 and 40 different bodies involved in one way or another in urban matters in Dhaka with little coordination and planning. As a result, there are major gaps in services and infrastructure ranging from weak electrical supply to inadequate land and housing options, and major traffic congestion. The poor

91 More than a quarter of firms in those cities reported that major floods were a major or severe obstacle to business, and 18.8% of firms in Barisal reported regular floods to be a constraint. Smaller firms were more sensitive than large ones on the issue.
92 DB SA 2007.
93 Ambar 2007.
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are particularly affected as they do not have the resources to find alternatives for meeting their basic needs. While a new committee for Urban Development was set up two years ago and has achieved some progress in the coordination process, it focuses on solving day-to-day problems and not on medium to long term strategy.

**Cities in Bangladesh do not have much autonomy to develop policies and provide public services.** Out of 522 urban areas identified in the 1991 Census Commission, only 295 have urban local governments (aside from the 6 city corporations, 289 have municipality status). In the remainder, services are provided by the field administration of the central government through its line ministries. Limited control over local sources of revenue stifle competition and incentives of local governments to attract business and provide better local conditions, as they rely mostly instead of central transfers. Institutional reforms to improve local management and governance hold the promise of correcting this imbalance.

**Non-metropolitan areas**

There are systematic differences in the characteristics of locations that are considered important in determining clustering of non-farm activities across regions. One of the most important determinants of density of non-farm activities is the “urbanization economies”: a larger urban center offers higher effective demand for products and allows a diverse set of activities to flourish. Urban centers also offer better infrastructure and other public services reducing costs of doing business. In terms of both density of population and percentage of household that are urban, the metropolitan areas naturally rank highest in Bangladesh. A typical thana in metropolitan areas has a population density of 7368 per square kilometer (Table 4.1). While median thana is completely urban, because of presence of rural population in some thanas which fall mostly within the city corporations (e.g. Barisal), average is 86 percent. About a third of households in peri-urban areas and a quarter in smaller towns (sadar upazillas) are classified as urban. While 76 percent of households in metropolitan areas have electricity connections, this percentage falls to 33 percent in peri-urban areas, 32 percent in smaller towns and 20 percent in rural areas. Similar trends in regional differences are observed in the case of percent of population who are literate. While there is no significant difference in the incidence of poverty between peri-urban areas and small towns, it is much higher in rural areas and much lower in metropolitan areas.

![Figure 4.1. Major or Severe Investment Climate Constraints](image)

*Source: Bangladesh ICS, 2007*

The smaller towns and rural areas fare poorly in terms of access to markets compared with metropolitan and peri-urban areas. While peri-urban areas are within 45 km of four major metropolitan areas (Dhaka, Chittagong, Khulna and Rajshahi) with population of 500 thousand or more, the smaller towns and rural areas are160 km and 190 km away from these major market centers. Rural upazillas are about 50 km away from smaller towns of population 50 thousand or more. While road density is relatively high in Bangladesh, yet much of the rural and smaller town locations still remain somewhat isolated from major market centers. A major factor contributing to this isolation is lack of bridges and other transport links that establish connectivity across major rivers criss-crossing the country.
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There are marked differences in the investment climate constraints faced by entrepreneurs located in different regions. As discussed earlier, low demand for goods and services is the most important constraint facing enterprises located in the peri-urban, small towns and surrounding rural areas (Figure 4.1). This constraint affects enterprises located in villages the most, about 44 percent of rural enterprises reported lack of demand as a major constraint compared with 41 percent in smaller towns and 35 percent in peri-urban areas. Access to electricity and unreliability of supply due to power outages are ranked higher by enterprises in peri-urban areas (22%) relative to small towns (12%) and villages (22%). Road inaccessibility is more of a bottleneck for village enterprises (28%) compared to peri-urban areas and small towns (9%). A significantly larger number of businesses in small towns identify political instability as a major/sever constraints (17%) compared to those in peri-urban areas and small towns.

4.2. Agglomeration, Spill-over and Location of Enterprise Location (Annex 5)

Non-farm activities in developing countries are often clustered in a few locations because of natural endowments of these locations (e.g. proximity to rivers, coasts etc) or because of infrastructure and amenities including agglomeration economies available at those locations.  

The agglomeration economies arise when locating near to other enterprises allows enterprises to learn from each other through knowledge and information sharing, to interact better with suppliers and customers and to avail a larger pool of workers with sector specific skills. Concentration of enterprises in a location also increases competition among enterprises forcing them to make productivity enhancing investments. The agglomeration externalities not only attract new entrants in a location but also improve productivity of individual enterprises. However, increasing concentration of activities in an area can also lead to congestion, pollution and transport and services bottlenecks. Without adequate investment in infrastructure and service provision, the diseconomies from congestion can more than offsets agglomeration economies choking off further growth of non-farm activities in that area. An understanding of location decision of the firms helps to highlight area-specific investment climate constraints and possible future direction of spatial concentration of non-farm activities. Both of these are important for designing placement of transport infrastructure and provision of urban and business services.

While non-farm activities in Bangladesh remain highly localized in metropolitan areas, these activities are spreading out to peri-urban and rural areas. According to the Economic Census, 2006, metropolitan areas accounts for 43% of total employment in 10+ enterprises, followed by rural areas (24%) and peri-urban (23%) (Figure 4.2). Between 2000 and 2006, employment in metropolitan areas remained flat while number of enterprises declined by an annual rate of 2.5% (Figure 4.2). In contrast, both employment and number of enterprises experienced substantial growth in rural (5.2% & 1.8% respectively) and peri-urban (4.4% & 2.5% respectively) areas. In contrast, small towns only experienced a slight growth in employment and number of enterprises. These four areas differ markedly in terms of their connectivity to major markets, of the amenities each provides and of overall investment climate constraints.

<table>
<thead>
<tr>
<th>Distance to</th>
<th>Metropolitan</th>
<th>Peri Town</th>
<th>Small Town</th>
<th>Rural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nearest city of population &gt;500k</td>
<td>21</td>
<td>45</td>
<td>160</td>
<td>190</td>
</tr>
<tr>
<td>Nearest city of population &gt;100k</td>
<td>14</td>
<td>26</td>
<td>64</td>
<td>78</td>
</tr>
<tr>
<td>Nearest city of population &gt;50k</td>
<td>10</td>
<td>21</td>
<td>21</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: Computed from Upazilla level Population Census, 2000 Data.

95 In order to ascertain the relative importance of infrastructure provision and agglomeration forces in determining the dynamics of clustering of non-farm activities, the location decision of start-ups is analyzed using unit record data from the 2000 and 2006 Economic Censuses of Bangladesh. The analysis has been carried out at two-digit industry and at upazilla levels.
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Analyses based on the 2000 and 2006 Economic Censuses indicate that start-ups (new firms) are likely to locate in an upazilla which offers larger markets (measured by its population) and more urban services (e.g. sanitation, garbage disposal, infrastructure building and maintenance). In deciding a place to start an enterprise, an entrepreneur considers the profit that s/he can earn from locating in different areas. The expected profits from locating in an area are influenced by infrastructure and amenities available at that location, the potential market size that firm can tap into, various externalities that the firm can expect to benefit from, as well as diseconomies of congestion, pollution and similar factors. In Bangladesh, urbanization economies measured by population density as well as the share of urban household in a location have a significant and positive role in attracting enterprise start-ups in a location (Table 4.2). Various agglomeration economies (competition, specialization and diversification) also play important roles in attracting start-ups in a location though their relative importance varies across regions. The degree of competition measured by number of firms per capita in an activity at a given location consistently increases the odds of a firm starting up, in all four regions--metropolitan, peri-urban, small town and rural (Table 4.2). It has been argued that competition attracts more productive entrants to a location which already has a concentration of that activity (Porter 1990). Except for metropolitan areas, larger firms prefer locations with a lower density of competitors.

Start-ups in peri-urban and rural areas seek out locations where there is an existing clustering of similar activities. The impact of specialization, measured by the share of a location in total employment of an activity, varies across regions. In peri-urban and rural areas, the positive externality from locating near similar firms outweighs congestion costs, offering opportunity for further clustering. On the other hand, in metropolitan areas, congestion costs seem to have neutralized positive externality from specialization as regression results suggest no statistically significant effect of specialization on entry of firms. Smaller towns are hubs of diverse sets of activities, and there is very little clustering of similar types of activities in these towns. Not surprisingly, specialization has does not have a significant effect in attracting new entrants in smaller towns.

Geographic concentration of various types of activities in a location also brings benefits to firms as it allows knowledge transfers across firms and makes complementary services available. The diversity of activities in an upazilla has a strong positive effect on an entrant’s location choice only in metropolitan and peri-urban areas. The regression analysis based on NMICA 2007 also confirms positive effect of specialization and competition on total factor productivity of firms located outside metropolitan areas.

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96 The start-up regression included dummies to capture any systematic differences in ICA constraints across regions, therefore the percentage of urban households in a location can be taken as a summary measure of availability of urban services (e.g. sanitation, garbage disposal, infrastructure building and maintenance).

97 The start-up regression included dummies to capture any systematic differences in ICA constraints across regions, therefore the percentage of urban households in a location can be taken as a summary measure of availability of urban services (e.g. sanitation, garbage disposal, infrastructure building and maintenance).

98 Diversity is measured as the inverse log of the Herfindahl index of employment concentration in a location.
The market size of growth poles (Dhaka and Chittagong) is also an important determinant of where firms locate in Bangladesh. The market size in growth poles is measured by the total population of the nearest growth pole deflated by distance from an upazilla to that growth pole. The market size of the nearest growth poles significantly influences firm location decisions in all areas except for small towns. In addition, specialization in growth poles has positive and significant effect on firm entry in metropolitan and peri-urban areas, and on entry of larger firms in rural areas. The market size in growth poles also has a positive impact on the productivity of firms located outside metropolitan areas.

**Specialization in medium towns (with population over 100,000) positively influences enterprise start-ups in small towns and rural areas.** Market size in the nearest medium sized town appears to have positive effect on start-ups in metropolitan and peri-urban areas. Larger enterprises are more likely to start up in small towns if the nearest medium sized town (with population over 100,000) has a larger market size and a concentration of enterprises in same activity. Specialization in nearest medium sized cities encourages entry into metropolitan areas but it discourages entry by larger firms in peri-urban areas. These results highlight the importance of access to markets as well as size of those markets in the location choice of start-ups. Firms are more likely to choose a location which has better access to markets and firms in growth poles and to some extent to those in medium sized cities.

Proximity to urban markets and to firms engaged in similar activities can benefit firms located in nearby areas because of various forward and backward linkages. Urban enterprises may engage in subcontracting relationships with nearby rural enterprises. Being closer to larger markets can also relax the demand constraints that plague rural enterprises. However, proximity to large urban areas is not an unmixed blessing for rural enterprises. Because urban areas offer better infrastructure and services and positive externalities, non-farm activities may migrate from rural areas to urban areas. Market size and specialization in the nearest growth poles exert significant influence on new entry, especially in metropolitan, peri-urban and rural locations. The spill-over from medium sized cities are weaker in magnitude.

### Table 4.2: Location Decision of Start-ups

<table>
<thead>
<tr>
<th></th>
<th>Metropolitan</th>
<th>Peri-urban</th>
<th>Towns</th>
<th>Rural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log(population)</td>
<td>0.301</td>
<td>0.301</td>
<td>0.301</td>
<td>0.301</td>
</tr>
<tr>
<td>(3.81)**</td>
<td>(3.81)**</td>
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<td>(3.81)**</td>
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</tr>
<tr>
<td>% of household urban</td>
<td>0.008</td>
<td>0.008</td>
<td>0.008</td>
<td>0.008</td>
</tr>
<tr>
<td>(5.67)**</td>
<td>(5.67)**</td>
<td>(5.67)**</td>
<td>(5.67)**</td>
<td>(5.67)**</td>
</tr>
</tbody>
</table>

#### Agglomeration Economies

| Specialization Index (SI) | 1.64        | 1.29       | 0.86  | 2.829 |
| (1.32)                  | (2.79)**    | (1.44)     | (9.17)** |       |
| SI* firm size (FS)      | 0.03        | 0.03       | 0.006 | 0.004 |
| (1.98)*                 | (8.61)**    | (1.66)     | (3.10)** |       |
| Competition Index (CI)  | 0.005       | 0.003      | 0.003 | 0.001 |
| (11.36)**               | (31.55)**   | (10.71)**  | (52.66)** |       |
| CI*firm size(FS)        | 2.0E-05     | -1.0E-05   | -5.0E-05 | -4.5E-06 |
| (3.85)**                | (8.29)**    | (3.72)**   | (10.47)** |       |
| Diversity Index(DI)     | 0.24        | 0.28       | -0.02 | 0.025 |
| (4.03)**                | (8.29)**    | (1.10)     | (2.03)** |       |
| DI*firm size(FS)        | 0.003       | -8.0E-04   | 2.0E-04 | 7.8E-5 |
| (0.75)                  | (1.84)      | (1.04)     | (0.88) |       |

#### Spill-over from Growth Poles

| Market size (MS)       | 2.90E-06    | 1.50E-06   | 1.20E-07 | 1.62E-06 |
| (13.34)**              | (9.87)**    | (0.55)     | (10.67)** |       |
| Specialization (SP)    | 9.95        | 6.17       | -3.88    | 3.29   |
| (7.27)**               | (5.08)**    | (1.41)     | (1.71)   |       |
| MS*Firm Size (FS)      | 1.3-E-11    | 3.60E-09   | 9.60E-10 | 3.23E-09 |
| (.01)                  | (3.86)**    | (0.62)     | (3.39)** |       |
| SP*FS                  | -0.035      | -0.012     | -0.0026  | -0.01  |
| (2.60)**               | (0.85)      | (0.07)     | (0.46)   |       |

#### Spill-over from City of size>100k

| Market size (MS)       | 2.28E-06    | 1.81E-06   | -1.56E-06 | -1.50E-06 |
| (3.80)**               | (5.56)**    | (1.83)     | (0.67)   |       |
| Specialization (SP)    | 7.55        | 2.27       | 2.56     | 34.48  |
| (2.51)*                | (1.42)      | (0.90)     | (2.51)*  |       |
| MS*Firm Size (FS)      | -2.73E-09   | -2.33E-09  | 6.85E-08 | -5.00E-08 |
| (.37)                  | (0.91)      | (2.80)**   | (1.52)   |       |
| SP*FS                  | -0.09       | -0.035     | 0.3      | 0.02   |
| (1.11)                 | (4.39)**    | (3.62)**   | (0.27)   |       |

**significant at 1%, ** significant at 5%

*Source: Bangladesh ICS, 2007*
Yet linkages and subcontracting can reduce input costs, improve cash management, lower in-house investment requirements, and increase efficiency, as well as assist the dissemination of technological know-how, spread risk, and stimulate the quality and financial standing of suppliers, especially in smaller towns and rural areas. Rural-urban linkages also have the potential to increase income generation in rural areas, aiding employment and poverty reduction, and transferring higher-value economic activity to the villages. Other rural-urban linkages, in employment, migration patterns, consumption, information, and remittance flows, can further strengthen these positive effects on rural development, though they are not within the purview of this report.
Chapter V  Productivity and firm performance

Metropolitan sample (Annex 6)

Investment in the country is reasonably high; however, the efficiency of utilization of resources is under question. In metropolitan areas, 38% of small and 67% of large firms reported investing in fixed assets or real estate. The highest investment occurred in garments (65% of firms made significant investments), textiles (60%) and chemicals / pharmaceuticals (64%). In non-metropolitan areas, 28% of firms made an investment in 2006, although larger firms were significantly more likely to invest. Fifty-seven percent of firms with 10 or more workers made an investment in 2006 as compared to 27% of firms with less than 10 FTE workers. Of the total investments in non-metropolitan areas in 2006, the sectors that attracted the largest investment were manufacturing of non-metallic mineral products—primarily brick manufacturing (52%), the food and beverage sector (13%), retail trade (8%) and textiles (5%). The median investment among enterprises with 10 or more workers was 35,000 Tk compared to 600 Tk for firms with fewer than 10 workers. The median investment across all firms was 700 Tk.

Capacity utilization was low on average – 79.7% in the country, with a significantly higher percentage in garments – 84.5%. Smaller firms had significantly lower capacity utilization than large – 77.4% versus 83.6%. The primary reason for capacity underutilization is electricity shortages (53.7% pointed that out). Other significant reasons included working capital shortages and suppressed demand (14% and 13.8% respectively). Particular factors were specific to particular industries, e.g. for the leather sector working capital shortages were particularly conducive to low capacity utilization (43.6% of leather firms agreed as opposed to an average of 14% overall), depressed demand was relevant for light engineering and chemicals / pharmaceuticals (26.8% and 36.5% versus an overall average of 13.8%), and local inputs shortages were detrimental to the food industry (20.2% versus an overall average of 6.9%). Small firms were particularly stunted by electricity and working capital shortages, more so than large ones (58% and 19.6%, respectively for small vs. 49.1% and 4.4% for large), who left insufficient demand to be relatively more worrisome than small firms did (12.4% vs. 15.4%).

Productivity growth during the 2003-2007 period, as before 2003,99 was not impressive, with inefficient allocation of resources even within the most productive sectors. Inefficiencies in resource reallocation due to imperfect markets and protectionism prevent the growth of the more efficient and productive firms, both within and across sectors. Finance shortages cause underinvestment and shrinking capital stock, which dampens productivity growth, especially in manufacturing. Smaller firms were significantly more productive than larger ones, yet were toiling under oppressive regulation and lack of access to finance, and forced into the grey economy where their contribution to growth is marginalized. One reason for that is the stiff entry and exit rules, which make it unreasonable to close down operations in expectation of changing future prospects and the difficulties in opening up business again. Another reason is the financial system, which allocates funds to those who have adequate collateral, as opposed to those whose business is productive and profitable. A third factor are overburdening regulations and weak property rights, which discourage risk-taking in search of a profitable innovative approach on the margin, since a significant part of the upside would be shared with outsiders in taxes, export requirements, graft, and regulatory compliance. A fourth culprit is the falling capital growth due to underinvestment and inadequate external (bank) financing, coupled with positive and strong employment growth. All this makes for inefficient resource allocation within the economy, and shaves points off from the growth percentage. A final key take-away note

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has to do with the effect of investment climate on productivity. As has been noted earlier, power shortages, complex and constraining regulation, low technology and innovation, low-skilled labor, and lack of international integration of firms lower their productivity.

The chemicals industry exhibits substantially higher labor productivity than other industries, followed at some distance by textiles, construction and transport, and machinery and equipment. The garments industry appears to be particularly efficient given that its capital intensity is much lower but its median labor productivity is only slightly lower relative to the machinery and equipment industry.

Across industries, both labor productivity and TFP are higher in Dhaka and Chittagong relative to Barisal, Khulna, Rajshashi, and Sylhet, across industries. Small firms are generally more productive or at least as productive as large firms in Bangladesh in all industries except machinery and equipment and chemicals. This finding may reflect the fact that large firms have easier access to finance than smaller firms. However, we will see below that the negative correlation between firm size and productivity is maintained even after controlling for firm access to finance. Further, younger firms are generally more productive or at least as productive as older firms in Bangladesh in all industries except other services. However, the differences in firm productivity across age categories are not very marked.

The econometric analysis shows a strong relationship between firm performance, firm characteristics, and investment climate factors, confirming the trends already seen above. Larger firms have lower labor productivity and TFP in Bangladesh, contrary to international evidence, and confirming earlier studies for the country. For example, firms with more than 50 workers exhibit on average 30% lower value added per worker and 19% lower TFP than smaller firms. In contrast, larger firms exhibit stronger employment growth than small firms. Firm size is not significantly associated with sales growth nor with profit margins. Older firms also display significantly lower TFP, lower labor productivity, lower sales growth, and lower employment growth than younger firms. Thus, firms aged more than 20 years old

Figure 5.2 Labor Productivity by Firm Size

Source: Bangladesh ICS, 2007

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Figure 5.3 Labor Productivity by Firm Age

Source: Bangladesh ICS, 2007

100 Models of industrial dynamics with firm heterogeneity predict a positive link between firm size and productivity (Jovanovic, 1982 and Hopenhayn, 1992). Endogenous growth models with increasing returns to scale also predict higher productivity for larger firms as these take advantage of economies of scale. Economies of scale have been shown to be important for the adaptation of new technology (Cohen and Klepper, 1996). The available empirical evidence points to a positive relationship between firm size and productivity in developed countries (Bartelsman and Doms, 2000) as well as in less-developed African countries (Van Biesebroeck, 2005). The Bangladesh findings were also obtained for on a different survey of firms in World Bank (2006).

101 The theoretical link between firm age and productivity is less clear-cut than the link between firm size and productivity. On the one hand, learning-by-doing arguments suggest higher productivity for older firms as their production experience accumulates (Malerba, 1992). However, learning-by-doing effects may be subject to strong diminishing returns (Young, 1991). Moreover, models of industrial dynamics with firm heterogeneity predict that larger firms are older and therefore suggest a positive link between firm age and productivity (Jovanovic, 1982 and Hopenhayn, 1992). On the other hand, younger firms are more likely to acquire and use capital of later vintages which is more productive than the industry average.

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exhibit on average 17% lower TFP than younger firms. Why are larger and older firms less productive despite economies of scale, learning by doing, and the fact that smaller firms face more adverse investment climate conditions, i.e., they are more burdened by regulation and have significantly less access to finance? Larger firms in Bangladesh benefit from subsidies and other privileges and are exposed to minimal entry into and exit from their industries. Thus, they are protected from competition and face little incentive to innovate and improve their productivity. Weak competition and financial markets also prevent resources from flowing to more productive smaller firms, enabling larger ventures to keep hoarding resources in spite of their lower productivity. Larger firms may also suffer from problems of coordination, management, and supervision as a result of poor corporate management and a lack of qualified middle managers. Anecdotal evidence suggests that these problems are pervasive in Bangladesh.

Foreign-owned firms perform significantly better than domestic firms in terms of labor productivity, TFP, and profit margins – foreign ownership adds on average 80% to TFP. This is due to advantages in terms of tangible assets such as better technology and in terms of intangible assets such as better access to distribution and marketing channels (Caves, 1996). However, foreign-owned firms exhibit significantly lower employment growth than domestic firms.

Garments exporters perform significantly better than non-exporters, as predicted by theory and international experience though the opposite is true in other industries. Exporters and non-exporters do not differ significantly in their sales growth nor their employment growth but exporters exhibit significantly lower profit margins than non-exporters in the garments industry. Exporters have 9% higher value added per worker than non-exporters in the garments industry and 22% higher value added per worker than non-exporters in other industries. In industries other than garments, the higher labor productivity of exporters relative to non-exporters is not matched by higher TFP. In efficient markets, only the best performing firms are able to afford the sunk cost of entry into export markets. Outside of the garments industry, that Bangladeshi firms are shielded from foreign competition and market forces, enjoying preferential treatment and subsidies, allowing lower-productivity outfits to survive despite being less productive while more productive firms which may not receive such protection would stand a better chance at surviving international competition in export markets.

Firms employing a higher share of skilled workers perform significantly better than other firms, as those skills enable firms to adopt new technologies, permitting also better decisions, organization, and work supervision. A firm which increases its skilled worker share by 24.5% (i.e., one standard deviation) would exhibit – with all else constant – 2.6% higher TFP. Firms that provide training to their workers also exhibit significantly higher productivity than firms that do not provide

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103 Wagner, 2007. The productivity advantage of exporters can be due to technological learning from foreign buyers (learning-by-exporting) but also to the fact that exporters improve their own technological capabilities in order to exploit profitable opportunities in export markets (self-selection of better firms into exporting). Self-selection and learning-by-exporting are not mutually exclusive hypotheses though, as better performing firms that can afford the sunk costs of entry into export markets may continue to improve productivity as a result of their exposure to exporting. Recent theoretical models such as Melitz (2003) rationalize this efficient market selection mechanism whereby only the best performing firms export since only they are able to afford the sunk costs of entry into export markets. Kee and Krishna (2007) caution, however, that demand shocks might also be important, in addition to productivity differences, in determining exports.

104 A skilled workforce is crucial for firms to adopt new and more productive technologies (Acemoglu, 1997 and World Bank, 2005). An unambiguous positive effect of human capital on growth is predicted by the endogenous growth models such as Lucas (1988) or Romer (1990). Skilled workers are also likely to contribute to better decisions, better organization, and better supervision of work (Rosen, 1982). Several empirical studies find important effects of employer-provided training on firm productivity in developed countries and in developed countries (e.g., Tan and Batra, 1995).
training. However, we find that firms employing a higher share of skilled workers or firms providing training to their workers exhibit significantly lower profits than other firms.\textsuperscript{105}

\textbf{Adopters of information and communications technology (ICT) proxied by the use of email or the web in firm operations exhibit significantly higher labor productivity and weakly higher TFP than non-adopters,} as ICT allows efficient information and product processing, as well as improved management and internal organization.\textsuperscript{106} Larger effects of ICT will be felt as an increasing number of firms adopt the technology. Internationally-recognized quality certification increase productivity, and R&D spending also significantly increases profits. Our estimates suggest that firms with a quality certification exhibit 25\% higher TFP than other firms. Firms with quality certification seem to grow less fast than other firms in terms of their sales and their employment, but the effects are weak. The effects of quality certification on profit margins are unclear. Quality certification is a proxy for the adoption of international industry standards and technical regulations, which may represent a more advanced technology than the average used in Bangladesh, permitting the upgrade of products and processes, increasing productivity, and easing entry into global supply chains.\textsuperscript{107}

\textbf{Firms with access to finance as proxied by larger loan values relative to their total assets exhibit significantly higher productivity and higher gross profit margins than other firms.} The availability of financing directly impacts investment, especially in machinery and innovation, and enables firms to improve production processes and efficiency. Cash-starved, especially smaller, firms operate without the ability to obtain equipment upgrades, and the skilled workers to operate it, nor can they acquire the tools to innovate or improve profit margins.

\textbf{Firms in industry-city cells experiencing a larger number of power outages exhibit lower labor productivity and lower TFP than other firms, though the effects are weak.} Firms more affected by power outages exhibit also lower sales growth, while the relationship between power outages and both employment growth and gross profit margins is unclear.

\textbf{Red-tape and crime adversely affect productivity.} Poor governance inflicts deadweight loss costs on firms, misallocates resources from more efficient firms to more connected firms, and creates market distortions. Among the surveyed firms whose managers spend a larger proportion of time dealing with regulation we find a disproportionate share of firms in the garments industry and a disproportionate share of exporters. This suggests that the heavy and complex red tape in Bangladesh is generating more hassle for the better performing firms. Crime-related costs divert resources from firm expansion and improvements and increase the degree of uncertainty in which firms operate with potential negative consequences for investment.\textsuperscript{109}

\textsuperscript{105} The financing of training for workers tends to fall largely upon the firms that provide it (e.g., Rosholm et al. (2006) show it focusing on firms in African countries. However, firms that provide training exhibit lower profits than firms that do not, controlling for all other characteristics.

\textsuperscript{106} A recent and growing literature has been mostly consensual in arguing that the adoption of ICT is associated with substantial improvements in performance of manufacturing and services firms across developed countries (Jorgenson, 2001 and Bosworth and Triplett, 2004) and developing countries (Basant et al. 2006, World Bank 2006, and World Bank, 2007). ICT can affect production processes, allowing faster processing of information and products, and improve management and internal organization. Moreover, ICT can allow for other productivity-enhancing changes - e.g., organizational changes such as decentralization - to occur. Qualitatively similar results are obtained when proxying for the use of advanced technology by the share of the firm’s workers that use computers.

\textsuperscript{107} Empirical studies for firms in developed countries suggest that the adoption of ISO is a crucial form of upgrading products and processes and increasing productivity (Blind et al., 2005 and Corbett et al., 2005). For firms in developing countries, ISO certification has the additional benefit of facilitating their entry into global supply chains (Humphrey and Schmitz, 2000).

\textsuperscript{108} Empirical evidence across developing countries shows that infrastructure quality has a significant positive impact on growth (Calderon and Serven, 2004) and on firm productivity (Escribano, 2007).

\textsuperscript{109} Krkoska and Robeck, 2006. Based on firms in Latin America and in the Caribbean (Gaviria, 2002 and World Bank, 2003) show the damaging effects crime on firm performance.
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The dynamic productivity analysis based on the 2003-2007 panel confirm the cross-section findings above. ¹¹⁰ Larger and older firms are less productive, suggesting that efficient market selection mechanisms may not be working. Firms increasing their share of skilled workers exhibit significantly higher labor productivity and significantly higher TFP on average than other firms. Firms that begin providing training to their workers as well as those introducing ICT and R&D also exhibit higher productivity. Firms gaining access to finance through an overdraft over the period perform significantly better than other firms on average, whether performance is measured by labor productivity or by TFP. The same findings are obtained for firms gaining access to finance through a loan. Firms in industry-city cells whose share of firms experiencing power outages increases over the period exhibit lower TFP if they do not own a generator. However, if they own a generator, increased frequency of power outages does not hurt their TFP. Poor governance, as well as increases in management time spent on red tape during the period of the 2003-2007 period is associated with lower labor productivity and TFP.

The Investment Climate and Firm Performance in Non-metropolitan Bangladesh (Annex 7)

Metropolitan firms are considerably more capital intensive and productive than their counterparts in peri-urban areas, small towns and rural villages. The annual value added per worker in manufacturing is four times higher in metropolitan areas, although the gap in services and trading is far less (Tk. 55,700 for non-metropolitan firms compared to Tk. 87,000 in metropolitan areas) (Figure 5.4). ¹¹¹ But even within non-metropolitan areas, there are striking differences in enterprise performance. Analysis of firm performance measured in terms of labor productivity (value added per worker), sales per worker, profits per worker and total factor productivity reveals that in addition to a firm’s characteristics, the investment climate also impacts firm performance.

Firm performance differs sharply across industries in non-metropolitan areas (Figure 5.4). Labor productivity is highest in trading enterprises (median value of Tk. 70,000 per FTE worker), followed by the services sector (Tk. 36,600 per FTE worker) and manufacturing (Tk. 23,400 per FTE worker). Econometric analysis of firm level labor productivity reveals that after controlling for firm size, capital intensity, different investment climate factors and characteristics of owners and workers, there are still significant difference by industry. Compared to textile manufacturers, who are among the least productive among non-metropolitan firms, furniture manufacturers, manufacturers of food and beverage products, and manufactures of rubber and plastic products perform significantly better even after controlling for other factors. Wholesale traders have significantly higher sales per work as compared to retailers but there are no significant differences in terms of total factor productivity.

Manufacturing firms with more educated workers (those with a larger share of workers that have completed primary education) perform better. These firms had significantly higher labor productivity, higher sales and profits per worker as well as higher total factor productivity (tfp). Garments manufacturers with more educated workers outperform their peers with higher total factor productivity.

¹¹⁰ While the panel sample covers only manufacturing firms located in Dhaka and Chittagong, it has two important advantages over the 2007 sample. First, the panel sample allows us to estimate the corresponding regressions by firm fixed effects: i.e., to control for unobserved firm characteristics that may be correlated with performance as well as with firm characteristics or investment climate variables. Second, the panel sample includes more variation over time – i.e., at two points in time - in the firm characteristics and the investment climate variables.

¹¹¹ Value added per worker of Tk. 55,700 is the median value added of all non-metropolitan services and trade enterprises taken together for comparability with the metropolitan services sector.
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productivity and higher labor productivity. However, controlling for other factors, there were no significant returns to higher human capital within the trading and service sectors.¹¹²

Firms with a larger share of hired workers have significantly higher total factor productivity across all three sectors. On average, close to 84% of workers in non-metropolitan enterprises are family workers, with the largest share of family workers in trading firms, followed by services and manufacturing. Older manufacturing enterprises and enterprises where the owner’s family has more experience in the non-farm sector also tend to perform better in terms of total factor productivity. Service sector firms that are household-based are less productive but there are no significant differences based on place of operation for manufacturing and trading firms.¹¹³

Female ownership of manufacturing and service sector firms is associated with significantly lower firm performance in a variety of dimensions. Women own about 30% of non-metropolitan manufacturing firms and 2% of service sector businesses. Median sales of women-owned manufacturing firms were approximately Tk. 8,200, twenty times lower than median sales of manufacturing businesses owned by men. The median value added per worker for women-owned manufacturing firms was about a third that of male-owned firms. However, manufacturing firms owned by women are more capital intensive than those owned by men, with assets per worker almost 30% higher than in firms owned by men. Even for textile and garments manufacturing, the two industries where female ownership is concentrated, labor productivity in female owned firms is only 60% of male-owned firms, but assets per worker are almost twice as large as that of male-owned firms. Manufacturing firms with female owners have 40% lower total factor productivity, while female ownership in the service sector is associated with 80% lower total factor productivity. Within the manufacturing sector, food and beverage firms owned by women were associated with higher productivity compared to those owned by men, but female-owned textile and garment firms had significantly lower total factor productivity.

The size of the local market (as measured by the population of the base mahalla or mouza where the enterprise is located) affects manufacturing and services firm performance. Low demand was the most frequently cited major or severe business constraint by non-metropolitan entrepreneurs. 48% of manufacturing firms, 47% of service sector firms and 33% of traders rated low demand as a major/severe constraint. The productivity analysis indicates that the size of the local market (as measured by the population of the base mahalla or mouza where the enterprise is located) is associated with significantly higher total factor productivity for both manufacturing and service sector firms. A 10% increase in the population of the community where the firm is located is associated with 2% higher total factor productivity for both manufacturing and services. The size of the local market is particularly important for firms with less than 10 workers. Connectivity and access to larger markets, proxied by the distance from the upazilla in which the enterprise is located to the nearest medium sized city is also an important determinant of firm performance, particularly for manufacturing firms. In fact, a 10% increase in the distance to the nearest city with 100,000 population is associated with 5% lower total factor productivity. The average enterprise was located in an upazilla about 64 km away from a city of 100,000. Proximity to the nearest large city is significantly beneficial for both small and larger manufacturing firms. Poor connectivity to larger markets is particularly detrimental to textile manufacturers (a 10% increase in the distance to the nearest city with 100,000 is associated with 9% lower total factor productivity for these firms). However, food and beverage manufacturers located further away from larger cities appear to perform better, possibly reflecting the advantages of being closer to supply sources or the fact that firms in better connected local markets face greater competition from large metropolitan manufacturing firms.

Better telecommunications connectivity is advantageous for traders and improves their firm performance. The potential endogeneity of phone ownership is addressed by using a measure of

¹¹² Manufacturing and service sector workers in general tend to have lower levels of education. Only 56% of workers in non-metropolitan manufacturing and services had primary school or higher education compared to 71% of workers in trading firms.

¹¹³ Manufacturing firms are significantly more likely to be household-based (68% are household-based), compared to 18% of trading and 7% of service sector firms.
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overall phone connectivity in the community (percent of households with a fixed line or mobile phone). As phone services can easily be rented or borrowed it is viewed as a good proxy. Among non-metropolitan enterprises, traders are significantly more likely to own a phone (41% owned a phone compared with 31% for services sector firms and 23% for manufacturing firms), an indication that these businesses are more reliant on good telecommunications. Being located in a community with better phone connectivity is also beneficial for food and beverage manufacturers but does not have a significant impact on firm performance for other types of manufacturing firms.

**Business network are also important for gaining knowledge of and access to more diverse markets.** The more suppliers and competitors firms are familiar with, the greater the likelihood that they are exposed to new market trends, innovations and products. These networks turn out to be quite important for the performance of non-metropolitan enterprises. Manufacturing firms that are located in mouzas/mahalas where entrepreneurs have more business networks (as measured by the average number of suppliers and competitors know to enterprises in the community) have significantly higher total factor productivity. The magnitude of benefits is small, but both small and large manufacturing firms benefit.

**Finance also featured prominently on the list of business obstacles identified by non-metropolitan enterprises.** The productivity analysis confirms that improved access to finance (the number of private banks within 5 km of the community in which an enterprises is located) is indeed associated with better firm performance, but the effect only holds for large manufacturing firms (those with 10 or more workers). Only 7% of enterprises applied for formal finance (3% applied to banks and 4% to NGOs/MFIs). The fact that access to finance only has a positive impact for large manufacturing firms can be explained by the fact that bank lending for microenterprises is extremely limited. 8% of firms with less than 10 workers applied for a bank loan compared to 38% with 10 or more workers. Access to banks is also positively and significantly associated with higher productivity for food and beverage manufacturing firms.

**Poor electricity supply disproportionately affects traders, textile manufacturers and food and beverage manufacturers.** These businesses are more affected as they are more dependent on electricity. 83% of traders had an electricity connection as opposed to 65% of manufactures and 68% of service sector firms. On average, 73% of non-metropolitan firms use electricity. These firms reported that they did not have power for about 30% of the working day. The remaining 27% of firms did not use electricity at all.

**The agglomeration economies also have a significant positive effect on the productivity of non-metropolitan firms.** Regression results show that both specialization and competition have statistically significant and positive effects on productivity. However, the index representing diversity has no significant impact on productivity. The proximity to markets in growth poles influences productivity of enterprises significantly and positively. In contrast, specialization in growth poles and in nearest medium sized towns seems to affect productivity negatively. When effects of all different types of specialization variables are evaluated at their mean values, the regression coefficients imply a positive influence of specialization on firm productivity.

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114 About 2% of firms had loans from more than one source.
115 In the firm performance regressions, firms that did not use electricity were assumed to have 100% of their days with outages. In general it is assumed that outages are exogenous. Firms that are connected to the grid do not have control over the number of hours of outages encountered. However since the variable also reflects who is connected to the grid it may suffer from potential endogeneity issues.

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Figure 5.5: Employment Growth

Source: Bangladesh ICS, 2007
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Manufacturing and trading enterprises were significantly more likely to have grown as compared to service sector firms. Total employment in non-metropolitan enterprises grew by 6% per year between 2005 and 2007, with the strongest growth in villages where total employment grew at 7.2% followed by peri-urban areas (6.5%) and small towns (4%). Of the total growth in employment between 2005 and 2007, 66% came from new entrants (firms that are less than 2 years old) and 34% from growth of existing firms. A larger share of the expansion in manufacturing employment (45%) came from expansion of existing firms, compared to trade (16%) and services (31%) (Figure 5.5).

At the firm level, 81% of firms experienced no growth in employment in the two years between 2005 and 2007, 11% experienced some growth and 8% of firms shrank in size. The average annual employment growth was 2%. In general, investment climate variables are not significant in regression analysis of employment growth. Within manufacturing there are significant industry specific effects on employment growth and more jobs seem to have been created for less educated workers. Closer analysis indicates that the industries that experienced higher job growth (manufacturing of non-metallic mineral products and textile manufacturing) tend to employ relatively poorly educated workers. Only 10% of workers working in brickfields and 40% in manufacturing of textiles have completed primary education, compared to an average of 60%.

Sixty-four percent of all non-metropolitan enterprises remained the same size since start-up. Only 4.4 percent of firms that started with less than 5 workers grew in size. Of those firms that had between 5-9 workers at start-up, 5.3% shrank in size, but 14.1% expanded in to 10+ firms. Among firms that had between 10-49 workers at start-up, about 11% graduated into the 50+ category while among those that started with 50 or more workers, 3.2 percent shrank in size and ended up in the 10-49 category.

Evictions and migration were the primary reasons for enterprises to close down. Approximately 7% of the households without enterprises reported that they had operated a non-farm business in the past 10 years which was no longer in existence. Of these households, 35% reported that their business had been evicted, 24% reported the business had closed down because a family member had left the community and 13% of businesses folded after a family member became ill or died.

<table>
<thead>
<tr>
<th>Workers now</th>
<th>Less than 5</th>
<th>5 to 9</th>
<th>10 to 49</th>
<th>50+</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers at start-up</td>
<td>Less than 5</td>
<td>95.6</td>
<td>4.0</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>5 to 9</td>
<td>5.3</td>
<td>80.6</td>
<td>13.5</td>
<td>0.6</td>
<td>100</td>
</tr>
<tr>
<td>10 to 49</td>
<td>6.0</td>
<td>3.8</td>
<td>79.4</td>
<td>10.8</td>
<td>100</td>
</tr>
<tr>
<td>50+</td>
<td>0.0</td>
<td>0.0</td>
<td>3.2</td>
<td>96.8</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>91.3</td>
<td>6.6</td>
<td>1.7</td>
<td>0.4</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Bangladesh ICS, 2007

116 The 2007 Non-metropolitan ICS had a non response rate of 9.4%. 70% of the non-response was due to firm closure/evictions. As part of the crackdown on corruption many businesses set up on/squatting on government land or without adequate building permits were evicted which is reflected in the non-response rate of the survey.
Chapter VI  Policy Options

In the past five years, there have been some positive government reforms, including improvements in customs rules and processing times (for certain sectors, import / export rules as well), reduced crime, increased regulatory and tax compliance. The automation of municipal licensing with a new interface provided by the Dhaka City Corporation (DCC) resulted in dramatic declines in the time to renew business licensing permits and accompanying improvements in governance and transparency. The effects of NBR modernization efforts have not been felt yet in a significant way, and collections remain low, though the nominal figures have increased this year by 25%. The challenge would be to continue this trend and make it sustainable. Similarly, ongoing and planned reforms of land registration are in their nature long-term and remain to bear fruit. While power sector improvements have to go a long way in order for changes to palpably take hold (in view of the extent of the problem), efforts there are ongoing. Mobile telecom deregulation has been strongly felt. The brunt of governance reform efforts came during and after the survey, and it was too soon for businesses to express opinions, but the country shows an improvement by 15 ranks per the latest Transparency International Governance Indices. Ongoing efforts in education would be further strengthened by sharper focus on innovation-related subjects (e.g. engineering) and ICT-enabling skills, as well as secondary and tertiary school reforms which will bear an effect on labor skills in the longer term.

The private sector reported they felt most of these reforms – 12.2% of metropolitan firms noted crime abatement, 11.5% emphasized also regulatory and tax compliance improvements, 6.1% - licensing, 5.2% - governance, 3.5% - tax administration, 3.4% - transport, 2.6% - import/export procedures, and mobile telecommunications. Challenges remain, particularly in the top five areas of obstacles to business as perceived by the private sector – electricity, political /economic stability, governance, access to land, access to finance, and labor skills. By addressing key investment climate constraints there is tremendous potential to raise growth and productivity. SEDF quotes that a 10% improvement in access to finance, the availability of skilled workers, reductions in electrical outages and corruption, could raise economic growth by one percentage point per annum, thereby producing the consequent flow-on effects to poverty reduction. Policy options in the most pressing areas as reported by business are outlined below (Annex 8 reviews in detail a wider and more thorough set of reforms in all areas of investment climate, pointing out also recent achievements).

- General conditions for business: Macroeconomic and political stability, governance and security

Macroeconomic stability has been significantly improved, with recent strengthening of Bangladesh Bank, financial market liberalization, steps to strengthen corporate governance, public administration and public sector financial management and procurement improvements, and a number of initiatives for better fiscal accountability and transparency, as well as the anti-corruption measures. A lingering preoccupation is inflation. The importance of political stability and governance came to the fore during the period. An independent Anti-Corruption Commission (ACC) Act was passed by Parliament in February 2004, establishing the Commission and providing it a mandate to prevent corrupt practices by public officials and investigate specific offences. The Caretaker Government has made a significant move in reconstituting the ACC, which is actively investigating corruption cases.

Recommenadation 1: Maintaining favorable macroeconomic conditions is indispensable for the growth aspirations of the private sector and the economy. In this respect, checking increasing inflation will be challenging. Continued governance improvement efforts would be of the essence as well.

- Electricity generation, distribution, and transmission

Private sector independent power producers (IPPs) are more efficient, produce electricity at a lower cost, and provide about 30% of total supply currently. State provision suffers from problems in governance, accountability, financial management, bad debt and collection rates, as well as physical capacity. The

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117 As documented by SEDF (2006) – IC survey, the ICA did not include telecoms as an option.
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Bangladesh Energy Regulatory Commission is operational and needs strengthening – one of the more needed BERC actions would be to reduce the lifeline 1st block of electricity tariff from 100 kWh. The recent unbundling of distribution companies, and their corporatization is expected to bring improvements. The potential of public-private partnerships in the power sector is being explored. Several recent initiatives have been promising - commercial losses have been reduced somewhat, financial strengthening and restructuring of power utilities is underway, and power supply reliability has also improved, with some decrease in load shedding.

**Recommendation 2: Power supply enhancements will directly feed into re-energized economic growth.** The electricity sector would further benefit from strengthening of the Bangladesh Energy Regulatory Commission; completing the corporatization of all operating companies, and addressing sector governance issues. New investment in the sector would continue to be stimulated by encouraging public-private partnership arrangements as well as transparency of contract awards and market friendly policies. Addressing inefficiencies in the state-owned energy sector, including governance and accountability, financial management, transparent accounting practices, bad debt and collection rates, would further improve power supply and system functioning, as would the introduction of more modern billing, metering and collection metering systems. Finally, tariff revisions would have a more palpable impact if they involve full implementation of time-of-day tariffs; sector finances would also benefit from a modification of the lifeline 1st block of electricity – this would actually have the effect of making the current system of subsidies less regressive.

- **Access to finance: bank downscaling to service MSMEs**
  The sector has experienced bold reforms since the 1990s. Recent reforms include improvements in prudential norms, corporatization and privatization of NCBs, reform of the Money Loan Court Act to allow creditors to sell collateral without a trial. An area where future bottlenecks would form if not addressed is the modernization of technology and lending methods, and overhaul of internal control structures, to make it possible for banks to service MSMEs profitably. Bank downscaling would segment borrowers by risk, broaden the product mix, eliminate reliance on collateral, minimize transaction costs, and generate deal volume, so as to maintain profitability. The legal and regulatory framework (especially rules on provisioning, credit bureau reporting, movable collateral, and collateral enforcement) would need to provide a more enabling environment as well.

**Recommendation 3: Bank downscaling would permit the transition from reliance on collateral to risk-based lending, segmentation of clients by risk levels, and diversification of the lending instruments.** Clients need to be segmented by the risk they carry, as higher-risk borrowers should face a higher interest rate. Several lending products should be offered, suiting differing client preferences. Lending should be based on better credit information, so as to assess client risk more precisely. The more effective sharing of credit information can be encouraged by supporting the computerization of the credit registry; allowing at least 2 years of historical data to be made available; expanding the registry’s coverage to include information on loans of less than US$800; and extending the credit registry to cover information from non-financial institutions, such as utilities, retailers and trade creditors. Collateral-requiring products should be complemented by risk-based lending products which do not require collateral, to attract the multitude of credit-worthy borrowers who do not have the required immovable assets. The collateral registry’s efficiency could be improved, including the strengthening of the movables collateral regime. Bank operational efficiency could be improved, to lower the cost and delays of administering small loans, and enable profitable lending by bulk. ICT could be used to simplify procedures, reduce costs, and speed up lending services. Regulations (provisioning, credit bureau reporting) which make it expensive to serve smaller firms could be revised.

- **Improvement in land market functioning and land administration**
  Jurisdiction of land administration is divided between the Ministries of Law and Land, with little or no coordination, and with municipal development bodies, such as RAJUK, also playing an important role. Procedures are manual, and complex, providing opportunities for graft and fraud, and mired in red tape and delays. Reforms of land registration / titling and use rules have started, including the amendment of the Land Registration Act and undertaking the Demra pilot on land records computerization, though by
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the nature of such reforms results can only be expected in the long term. Property registration procedures are some of the longest in the world (425 days in Dhaka). Registration fees and stamp duties are some of the highest in the region.

**Recommendation 4: Improvements in land administration are critical to better land use and land markets.** To this end, policymakers should forge ahead by building on the experience of the Demra pilot in a phased roll-out of land records computerization. Land administration issues should be re-focused under a single Ministry, to improve coordination and reform effectiveness. There is further scope for reduction of registration fees and stamp duties, as well as streamlining of procedures that would result in substantial reductions in the time required to register property.

- **Labor skills shortage and mismatch; gender issues**

Bangladesh manufacturing labor is cheap, and has been growing fast, but is of low productivity. In September 2006 the government passed a new labor law granting limited workers’ association rights in the export-processing zones effective November 2006. Despite light labor regulations, structural barriers impair the efficiency of the labor market, including mismatches between economic performance and labor allocation, pressure from the public sector, skills shortages. Skills shortage and mismatch issues, perceptions for low skills of migrant workers, and inadequate levels of in-service training can be linked to shortcomings in the country’s secondary and higher level education and vocational system. Secondary and tertiary education improvements should be pursued over the long run as their returns are high in terms of poverty and incomes, with vocational and technical training strengthening in the short term to prop up the system. One promising initiative is sustained by the Bangladesh Garments Manufacturers and Exporters Association, which has established a fully self-financed training institute of its own, the BGMEA Institute of Fashion and Technology to meet the requirements of its industry.

A growing number of women in Bangladesh are participating in the labor force, facing considerable barriers and lower wages. Female entrepreneurs are less educated and have significantly less access to enterprise finance. Attention to developing female labor skills and access to finance, are vital to address gender issues in Bangladesh.

**Recommendation 5: Addressing the labor skills shortages and mismatches require improvements in higher education, and short-term stop gap vocational training measures.** Initiatives such as the BGMEA Institute of Fashion and Technology (BIFT) should be encouraged. Particular emphasis should be placed on (1) ICT / engineering skills; (2) migrant worker skill needs; and (3) girls’ education and gender needs.

**Recommendation 6: Gender issues require careful and aggressive attention as well, via promotion of female employees’ labor skills, as well as access to finance and business support services to women entrepreneurs.**

- **Connectivity – market linkages, telecommunications, and transport**

Low demand is perceived as the most serious obstacle to doing business in non-metropolitan areas. Access to larger markets significantly influences enterprise perceptions of demand, yet access to markets is often hindered by inadequate market-related know-how and limited capacity for market research among non-metropolitan enterprises. Infrastructure bottlenecks (bad road conditions, congestion and poor integration of different transportation modes) compound these problems. Microenterprises would significantly benefit from interventions targeted to improving entrepreneurial skills particularly with respect to gathering market information, undertaking market assessments, and business and financial planning. There are many NGO and donor projects currently being implemented with the objective of supporting the growth of micro and small enterprises (MSE), fostering the supply of business development services to MSE, and strengthening business organizations/producer groups catering to micro and small enterprises. There is a real need for evaluating the impact of these initiatives/projects to scale up the approaches that deliver the best results. Interventions that strengthen linkages between micro and small enterprises and larger firms would also be beneficial. Poor contract enforcement currently prevents more widespread sub-contracting among firms. Market connectivity is essential for stimulating the
growth of non-metropolitan areas, including via transport, telecommunications, subcontracting, as well as financial and technological linkages.

Competition has gradually been introduced over the past 10 years to the state Bangladesh Telegraph and Telephone Board (BTTB), which suffers from poor performance and capacity constraints. This has resulted in a booming mobile telephone sector (fixed telecoms are expected to follow, after the recent opening of the fixed line network for competition). Other benefits of competition have included lower tariffs and a functioning market (not least due to the Bangladesh Telecom Regulatory Commission) which effectively develops fast, solving teething problems such as interconnectivity as it goes. Further improvements to be addressed include spectrum management, interconnection, and BTRC funding. The transmission and backbone infrastructure could be addressed to expand broadband services. Competition in international long distance could be further improved. BTTB could be restructured to make it more competitive, enable a better maintenance of its network, and enlarge its product mix.

The road and inland water transport sectors have been competitive and dynamic. The railway network in Bangladesh is state-owned, segmented (the opening of the Jamuna bridge in 1998 helped in this regard), and financially and operationally inefficient. It is losing market share to road transport and high-capacity trucks. The National Land Transport Policy 2004 and the Railway Recovery Program with the ADB aim to address these concerns, though restructuring plans have met with resistance. Opening rail traffic with Nepal and Bhutan would also improve regional integration.

**Recommendation 7:** Market connectivity is thus essential for stimulating the growth of non-metropolitan areas, including via technical assistance for micro and small enterprises on marketing and business planning and improved transportation networks and telecommunications. In particular, telecommunications would be further strengthened by revamping BTRC to improve its funding, make it more competitive, enable a better maintenance of its network, and enlarge its product mix. Other areas of improvement include addressing the transmission and backbone infrastructure to expand broadband services, improvements in competition in international long distance, and in spectrum management and interconnection. The transport system would benefit from better financial and information management, procurement, operational risks (both roads and rail), spending control, the Road Maintenance Fund, and establishing a transport policy review process. Open rail traffic with Nepal and Bhutan will improve regional integration. Intervention/projects focused on strengthening entrepreneurial skills in marketing, business and financial planning for micro and small enterprise will also be beneficial.

- **Innovation and technology**
Weak innovation and low investment in technology constrains productivity enhancements in both rural and urban areas, governance and efficiency improvements. Innovation can be spurred by increasing both domestic and foreign competition, as firms strive for better performance and market share. Interaction with foreign firms promotes technology and other spill-overs.

**Recommendation 8:** Liberalization of trade protection, and other competition-promotion policies, would intensify learning, innovation, and technology improvements. Better market connectivity would strengthen technological, financial and information exchange between larger and smaller companies, as well as urban and rural ones. An enabling framework for leasing would strengthen the ability of SMEs to finance innovation and technology absorption. Diffusion and absorption of knowledge and innovation could be further stimulated, including via Business Associations and NGO support services. Existing public programs for innovation and early-stage technology development could be reviewed and evaluated, building on successful programs paying particular attention to supporting grassroots innovation projects. Educational reforms with an emphasis on IT and engineering as well as an upgrading information infrastructure would intensify learning, innovation, and technology improvements.

- **Red tape, regulations, and governance**
Investment regulations including number of clearances have been sharply reduced. Private investment facilitation has been strengthened. Licensing has been speeded-up. The Bangladesh Better Business Forum was established to veil over investment climate facilitation. The e-government processes
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implemented by the Board of Investment (BOI) and Bangladesh Export Processing Zones Authority (BEPZA) have helped streamline the business registration process and other investor services. However, institutional weaknesses in administrative and public services persist, hassling foreign and domestic entrepreneurs alike, and hurting FDI, domestic investment, and growth. There are several well-established and effective lines of attack on red-tape hassle, including further streamlining, strengthening of the responsible institutions, as well as reliance on IT to improve accountability. In international experience, significant success has been noted for regulatory competition as a factor for red tape reduction. In India and Russia, competing states have rushed to lower red tape in a bid to attract business (and tax revenues).

Recommendation 9: Red tape and potential weak governance created via regulatory complexity could be counter-acted by improving information provision, introducing online services, and decreasing reliance on inspectors, further streamlining regulations where possible (e.g. tax administration, company registration), strengthening responsible regulatory institutions, and employing IT (e-government, computer-handled records) to improve transparency and accountability. The introduction of regional / inter-city regulatory competition has proved to aid this process tremendously, in international experience.

➢ Tax administration
A comprehensive tax administration modernization program is being developed, to improve collections, modernize and computerize NBR, and reengineer processes. There are 106 tax holidays (as identified in 2005, see the summary of tax rules in the box overleaf), which are ineffective in investment promotion and widely abused. Complex tax procedures create corruption opportunities, which can be eliminated via simplification of the tax regime. The government can also encourage compliance by reducing tax rates to more moderate levels. Corporate income tax in Bangladesh accounts for the bulk of total tax revenues, and at 40% is the highest in the region. Such high rates encourage tax evasion. The challenges, then, in the areas of taxation, can be summed up to: improving tax compliance, streamlining tax rules and lowering administrative hassle, reducing tax rates. Revenues can be maintained or even increased if the tax rate is decreased along with broadening the tax base, as the case of Egypt shows (see Annex 8).

Recommendation 10: Tax compliance could be further improved via computerization and better enforcement. Tax collections would be strengthened by streamlining tax rules, lowering administrative hassle, and reducing tax rates while broadening the tax base.

➢ Courts
The legal processes for separating the judiciary from the executive have been completed, signaling a major step towards an independent and functioning judiciary. Amendments to the Civil Procedure Code adopted in 2003, introducing mediation and imposition of heavy costs on parties seeking more than three adjournments, have helped reduce the number of cases going to trial and case processing times. In several pilot districts, court administration has been strengthened through case management reforms, automation and upgrading of facilities, and these pilots could be extended to other courts. The creation of a Judicial Administrative Officer (JAO) post, in charge of the Central Filing Office (CFO), will also improve the efficiency of the courts. Alternative dispute resolution mechanisms have been adopted. Enforcing contracts can be sped further by computerizing and linking the courts’ databases, to eliminate double-fining of cases. India has made huge strides towards computerization of its courts. Strengthening judicial training, and upgrading facilities and other human resource needs would increase efficiency, effectiveness, and accountability. Bangladesh recently introduced a maximum number of adjournments before the Money Loan Courts. The Money Loan Courts do not deal with all types of commercial disputes that can arise between businesses. Developing specialization in commercial disputes by training judges is also important for unclogging the courts. Gambia and Nigeria nearly halved the time to enforce a contract after they introduced specialized commercial courts. Finally, allowing private enforcement of judgments through bailiffs may expedite dispute resolution.

Recommendation 11: Courts could be further strengthened by extending case management pilots nationwide, computerizing and linking the courts’ databases, strengthen judicial training, and
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**upgrading facilities and other human resource needs.** Other strategies for improvement which have succeeded internationally include developing specialization in commercial disputes by training judges, as well as allowing private enforcement of judgments through bailiffs.

- **Promoting exports**
Trading across borders has seen a number of recent improvement initiatives. Private operation and management of Chittagong Container Terminal (CCT) started functioning in March 2007, which has helped improve overall handling operations (see box in Annex 8). Port efficiency has increased by 30 percent and cost of doing business in the port has decreased by 40 percent. Steady progress is being made on trade liberalization since 2002, but further simplifications in the import-tax regime are needed, as well as a reduction of the dispersion and average level of nominal (and thus effective) protection. Several further reform opportunities include economic zone development and further streamlining of trade procedures (see, for example, the success case of the Karachi Customs in the box in Annex 8). Customs procedures could be further simplified by combining different inspections, going online, measuring delays at the border, and increasing customs bonded facilities, to allow for efficient handling and transit of legitimate import-export trade flows. Railway container services could be put on a commercial footing. The reliability of air-freight service could be improved. In addition, further investment in port equipment and streamlining of processes / fees is needed, in particular on the import side.

**Recommendation 12: Further export strengthening would be facilitated by continuing with the simplifications in the import-tax regime, and reduction of the dispersion and average level of nominal protection, preferably through a pre-announced medium- and long-term schedule of reductions, while avoiding direct export subsidies. The development of economic zones should be continued. Trade procedures could be further streamlined. Efficiency of customs procedures could be improved and rent seeking eliminated by combining different inspections, going online, measuring delays at the border, and increasing customs bonded facilities. Other related initiatives include putting railway container services on a commercial footing, improving the reliability of air-freight service, and further investment in port equipment and streamlining of processes / fees is needed, in particular on the import side.**

- **Facing locational challenges outside of Dhaka and Chittagong**
The two largest urban centers – Dhaka and Chittagong, have concentrated much of the economic activity in Bangladesh, benefitting from access to labor, public services, markets, and other agglomeration advantages. Yet there are signs that the congestion costs in some areas are outweighing agglomeration benefits, as visible in the high land prices, commuting costs, pollution, and bottlenecks in infrastructure and service provision.

Dhaka (and other major cities) will continue to attract rapid population growth unless other urban centers become viable investment decisions, via institutional reform, provision of serviced land, enhancement of own source revenues, as well as investments in inter regional infrastructure to de-concentrate standardized manufacturing. The country does not have a comprehensive policy on urbanization and urban poverty. There are between 16 and 40 different bodies involved in one way or another in urban matters in Dhaka with little coordination and planning. With limited local fiscal autonomy, local governments cannot make alternate locations attractive to business and spread development across the urban hierarchy. The distorted urban system translates into lost opportunities for economic growth, of an estimated value of 2 percentage points.

**Recommendation 13: Growth outside of the Dhaka – Chittagong agglomerates could be stimulated further and unleashed by empowering local governments in alternative metropolitan areas to compete over the provision of hospitable conditions to attract business, including serviced land and an adequate regulatory environment. Institutional reforms to improve local governance and management of resources and costs, including in Dhaka, hold the promise of decentralization and improved potential for other cities as viable investment destinations. Specifically, municipalities should improve their revenue and budget management, infrastructure development and service provision. The ability of**
Pourashavas to provide local services that are valued by local residents should be enhanced. Land use and housing market reforms are needed to increase access to serviced land and address price imbalances. Further investments in inter-regional infrastructure are needed to de-concentrate standardized manufacturing.

- **Stimulating the non-farm activities in areas outside of the two main metropolitan centers -- Dhaka and Chittagong**

Stimulating non-farm activities in areas outside of the two main metropolitan centers -- Dhaka and Chittagong – will be important for overall economic growth and poverty reduction in Bangladesh. Although these two cities represent the highest level of clustering in the country, congestion costs are outweighing the benefits of agglomeration. While investment in urban services and reforms in urban management are required to improve the overall investment climate in those cities, they are unlikely to relax the land constraint imposed by the rivers particularly in the case of Dhaka. Compared with Dhaka and Chittagong, other cities, peri-urban and rural areas offer many advantages in terms of availability of cheaper land and labor, and little or less congestion. Expansion of non-farm activities in those areas is also desirable from the point of view of balanced regional development and poverty reduction.

Growth of non-farm activities in areas outside of the two main metropolitan centers would require removing major constraints faced by those areas. Provision of services as well as infrastructure in peri-urban and rural areas, and small towns need to be guided by the presence of agglomeration economies along with market access as return to investments are much higher in places where agglomeration economies are present. Provision of services and maintenance of infrastructure in peri-urban areas should be a priority for the development of non-farm activities in Bangladesh. As firms prefer rural locations with greater clustering of activities, provision of services for rural areas should target rural areas with natural advantage (e.g. less susceptible to flooding, lower crop suitability, larger population) allowing these areas to become growth poles within rural areas. Investment in an efficient transport system is needed to facilitate clustering of activities in rural areas with natural advantage. Development of the transport system will rely on relieving congestion, integrating different modes of transportation, proper management of waterways, and continuing/implementing reforms in ports and railways. When it comes to small towns, GoB needs to re-assess its current strategy of thinly spreading its resources over a large number of locations (Pourashavas and growth centers). A bigger push in developing medium sized cities with better natural resources and infrastructure access may offer a better option to optimize the growth potential of non-farm activities. A more efficient transportation network would also spur growth of non-farm enterprises in small-towns.

**Recommendation 14:** *Growth of non-farm activities in areas outside of the two main metropolitan centers would require removing major constraints in provision of services as well as infrastructure. Provision of services for rural areas should target rural areas with natural advantage (e.g. less susceptible to flooding, lower crop suitability, larger population). Investment in an efficient transport system is needed to facilitate clustering of activities in rural areas with natural advantage. The current strategy of thinly spreading its resources over a large number of locations (Pourashavas and growth centers) should be reassessed, in favor of a bigger push in developing medium sized cities with better natural resources and infrastructure access. As peri-urban areas are experiencing the fast growth in non-farm employment, provision of services and maintenance of infrastructure in these locations areas should be a priority. These are also areas where the rural-urban transformation is taking place and there is a need for more orderly expansion and smarter growth in these areas.*
## SUMMARY OF RECOMMENDATIONS

<table>
<thead>
<tr>
<th>Short Term</th>
<th>Medium Term</th>
<th>Long Term</th>
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<tbody>
<tr>
<td><strong>Macroeconomic stability</strong></td>
<td>Careful monitoring of inflation pressures</td>
<td>Continue general policies of maintaining macroeconomic stability</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>Strengthen BERC</td>
<td>Revise the size of the lifetime (1st block). Fully implement time-of-day tariffs. Promote PPPs. Complete corporatization of all operating companies. Address sector governance issues. Introduce more modern billing, metering and collection metering systems.</td>
</tr>
<tr>
<td><strong>Banking sector modernization</strong></td>
<td>Upgrade the legal and regulatory framework, including for MSMEs, especially rules on provisioning, credit bureau reporting, movable collateral, collateral enforcement.</td>
<td>Improve the collection and sharing of credit information, by supporting the computerization of the credit registry; allowing at least 2 years of historical data to be made available; expanding the registry’s coverage to include information on loans of less than US$800; and extending the credit registry to cover information from non-financial institutions, such as utilities, retailers and trade creditors.</td>
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<tr>
<td><strong>Land market functioning and land administration</strong></td>
<td>Concentrate and focus responsibility for land policies within a single Ministry to strengthen the case for reform.</td>
<td>Continue with land registration /titling reforms; scale up the Demra pilot on land records computerization nation-wide. Review registration fees and stamp duties, and streamline procedures.</td>
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<tr>
<td><strong>Labor skills shortage and mismatch</strong></td>
<td>address labor skills shortages / mismatch via short-term stop gap vocational training measures. Encourage initiatives such as the BGMEA Institute of Fashion and Technology.</td>
<td>Address the labor skills shortages and mismatches via improvements in higher education. Particular emphasis should be placed on (1) ICT / engineering skills; (2) migrant worker skill needs; and (3) girls’ education and gender needs.</td>
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<tr>
<td><strong>Gender issues</strong></td>
<td>Promote business support services to business women.</td>
<td>Promote female employees’ labor skills and training, as well as access to finance.</td>
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<tr>
<td><strong>Connectivity – market linkages</strong></td>
<td>Improve entrepreneur skills, e.g. gathering market information, market assessments,</td>
<td>Further improve access to markets via infrastructure improvements (road conditions, decongestion and</td>
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<table>
<thead>
<tr>
<th><strong>Telecommunications</strong></th>
<th><strong>Transport</strong></th>
<th><strong>Innovation and technology</strong></th>
<th><strong>Red tape, regulation, and governance</strong></th>
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<tbody>
<tr>
<td>Re-vamp BTRC to improve its funding, competitiveness, enable a better maintenance of its network, and enlarge its product mix.</td>
<td>Establish a transport policy review process.</td>
<td>Stimulate knowledge / innovation diffusion and absorption (also via NGO / Business Associations support services. Review and foster an enabling framework for leasing.</td>
<td>Further streamline regulations where possible (e.g. tax administration, company registration). Improve information provision, introduce online services, and decrease reliance on inspectors.</td>
</tr>
<tr>
<td>Address the transmission and backbone infrastructure to expand broadband services, improve competition in international long distance, and in spectrum management and interconnection.</td>
<td>Open rail traffic with Nepal and Bhutan to improve regional integration.</td>
<td>Intensify learning, innovation / technology improvements via education reforms; stimulate both domestic and foreign competition and trade liberalization. Review and evaluate existing public programs for innovation and early-stage technology development, and strengthen best practice and grassroots innovation.</td>
<td>Strengthen the responsible regulatory institutions, increase reliance on IT (e-government, computer-handled records) to improve transparency and accountability. Foster regulatory competition among different regions / cities, empowering them by decentralizing some regulation-related administrative / implementation functions.</td>
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<td><strong>Tax administration</strong></td>
<td><strong>Courts</strong></td>
<td><strong>Promoting exports</strong></td>
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<tr>
<td>Continue the ongoing tax administration modernization program.</td>
<td>Strengthen judicial training, increase specialization, upgrade facilities and other human resource needs.</td>
<td>Simplify further the import-tax regime. Increase investment in port equipment and streamline further the processes / fees,</td>
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<td>Increase tax compliance via better enforcement and computerization.</td>
<td>Computerize and link the courts’ databases, to eliminate double-fining of cases and speed up contract enforcement.</td>
<td>Continue with the economic zones development policies. Further streamline trade and customs procedures, by combining different inspections, going online, Put railway container services on a commercial footing. Improve the reliability of air-freight service. Gradually reduce the dispersion and average level of nominal</td>
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Harnessing competitiveness for growth: How can we enable business for jobs and prosperity

| Facing locational challenges outside of Dhaka and Chittagong | Formulate a comprehensive policy on urbanization and urban poverty. Improve coordination of all bodies involved in urban matters in Dhaka. | Enhance the ability of Pourashavas to provide local services that are valued by local residents. Increase access to serviced land and address price imbalances via land use and housing market reforms. Introduce further investments in inter regional infrastructure to de-concentrate standardized manufacturing. | Empower local governments in carefully chosen metropolitan areas to improve investment conditions and attract business, via institutional and regulatory reform, provision of serviced land, enhancement of own source revenues, as well as investments in inter regional infrastructure to de-concentrate standardized manufacturing. Improve local governance and management of recourses and costs, including in Dhaka. |
| Stimulating the non-farm activities in areas outside of the two main metropolitan centers -- Dhaka and Chittagong | Develop a strategy for improving provision of services and infrastructure in peri-urban and rural areas and small towns. | Implement the strategy in areas of agglomeration economies along with market access, avoiding the thin spreading of resources over a large number of locations, e.g. target rural areas with natural advantage (e.g. less susceptible to flooding, lower crop suitability, larger population). | Improve transport system efficiency, integrating different modes of transportation, proper management of waterways, and continuing/implementing reforms in ports and railways. |
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Annexes
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