

The Economic Development of Bangladesh: Identifying Pragmatic Policy Responses

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(in Mahfuz Ullah ed. (2011) *Bangladesh Tomorrow*. Dhaka: CFSD pp.11-68)

This paper does not intend to summarize all the achievements and problems of the Bangladesh economy or the economic challenges facing us in the future. I presume readers will be well-informed of the contours of our economic development and the challenges we face. Instead, I wish to argue that we need to think both radically *and* pragmatically to identify the critical strategies and policies that can help take Bangladesh into the ranks of middle income countries, and indeed to transform the country into a self-confident regional player enjoying broad-based development. The challenges we face have common features with other developing countries. We need to learn from the experience of other countries as well as our own experiences with growth and development. In particular, I want to argue that finding sustainable solutions in developing countries often requires identifying a small number of potentially implementable institutions and developing agencies that are most likely to make an impact given our understanding of the political economy constraining the development process. Reform efforts are most likely to work if they focus on a small number of areas and if the political leadership focuses on building a national consensus supporting the importance of building the institutional and political capabilities for addressing a small number of core developmental issues. The analytical challenge is to identify the implementable solutions that may make an impact on the potentially significant problems that a developing country like Bangladesh faces. In this paper I suggest as examples a number of areas where the development of institutions and institutional capacity is vital and could make a significant difference to development outcomes. These areas are not necessarily exhaustive but give an idea of the type of thinking we need to engage in based on international experiences.

The importance of building institutions and achieving a national consensus supporting important institutions is of course well recognized. But the dominant international policy discourse has identified a governance agenda for developing countries that is actually not appropriate and which has proved very difficult to implement to any significant degree. The well-known dominant discourse within the economics discipline and global policy institutions suggests that developing countries should focus on building a set of ‘good governance’ institutions and policies that can in theory make markets more efficient. Indeed, the entire ‘good governance’ and liberalization agenda is underpinned by an economic and institutional theory that suggests that these reforms (if they can be effectively implemented) would achieve efficient market economies. This Western discourse and its salience in our own policy circles are well known. There is a powerful body of policy-makers who argue that we can ensure long-term development by focusing on institutionalizing market liberalization and building institutions of good governance that will in turn create an good ‘investment climate’ for investors. While these ideas are based on plausible

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economic theories, the global evidence of successful development and even the evidence from Bangladesh suggest that many of these good ideas are not implementable in poor countries to an extent that can make a significant difference in the short to medium term. The poor countries that did develop dramatically in the last century did not do so by first implementing the reform package suggested for them, but by building effective policies and governance capabilities that addressed particular problems that were constraining their development. When we look at this historical experience more closely, we find that a rather different focus for policy and politics is required for sustaining growth and development. The political challenge is to discuss and agree on feasible and effective policy based on the best available economic evidence from countries that have actually succeeded. A parallel and equally necessary challenge is to construct the political constituencies supporting such a programme.

The next section briefly summarizes the broad economic challenges, which are widely recognized and not controversial. I cannot attempt to deal with all these areas so I will instead pick on a number of vital areas that I believe pose constraints for sustaining development. In each of these areas, the achievement of good governance and efficient markets *could* in theory provide solutions. But in reality, good governance reforms are not substantially implementable in developing countries and therefore when we look at the experience of successful countries we always find that very specific, pragmatic and sometimes accidental solutions have addressed important problems that needed to be resolved. Our challenge is to learn from these experiences, both those of other countries and our own, so that we can identify a small number of implementable institutions and capabilities that are most likely to make an impact. I look briefly at three important constraints that are important to overcome for sustaining development based on our own experiences and those of other countries. The first is the challenge of creating new productive capabilities rapidly so as to diversify and extend the productive sector. The second is to devise feasible institutional and political solutions to address the issue of land use and natural resource extraction. And finally, there is the issue of power generation. But first, I begin by briefly summarizing the range of developmental challenges in Bangladesh, though I presume these are well known to readers. I then outline why the conventional policy responses based on market-promoting ‘good governance’ strategies are insufficient for addressing these problems. Finally, I discuss the types of strategies and governance priorities that are required for addressing a range of important problems in the future.

1. Summary of Economic Challenges

There is broad agreement about the main challenges facing the economy of Bangladesh. Nevertheless, it is useful to summarize some of the issues before we begin to discuss the adequacy of existing policy responses. If we read the policy papers produced by a range of agencies and think tanks within Bangladesh and beyond, it is clear that most economists and policy-makers agree on the main contours of the challenges facing us. The policy question is really what should we be doing about it, what types of policies are feasible, and what types of governance and institutions are required to make these policies implementable? There is also a question of prioritizing problems and setting a national agenda for development. The

list of challenges is potentially long, but a number of areas stick out in terms of their salience and immediacy.

Industry

The key features of our economic growth over the last decade are summarized in Appendix Table 1. Clearly, over the long run, industry and manufacturing have been the fastest growing sectors in the Bangladesh economy, and this accounts both for the growing share of GDP coming from industry and manufacturing and the growing share of total employment accounted for by these sectors². In recent years the share of our GDP coming from industry has climbed to close to thirty per cent and manufacturing alone accounts for almost twenty per cent. Around fifteen per cent of the workforce is employed in industry. Industry and manufacturing are likely to remain drivers of growth into the future and it is desirable that they should. This is because the best way of providing large scale new employment to our growing workforce and thereby effectively reducing poverty is through the creation of employment in labour-intensive manufacturing sectors. Sustaining growth in manufacturing requires overcoming a number of constraints. Some of these constraints are quite extensively discussed in the existing policy literature even if adequate answers have yet to be found: like improving the availability of power and the quality of infrastructure. But other important constraints are not even adequately identified. These include the missing institutions and incentives required to build new productive *capabilities* in manufacturing so that new sectors can be opened up and existing production can move up the value chain.

Our manufacturing sector has done very well in the last three decades, but it is dominated by a single sub-sector, garments and textiles. The dramatic growth of this sector since the 1980s has been a source of pride for the country. The sector clearly has significant further potential, but a mono-focus economy is vulnerable as we discovered when our focus was on the jute industry and we began to lose global markets in the 1970s. The recent demands for better wages and conditions in the garment industry also show that to sustain our share of world markets in this sector, productivity has to improve and the industry has to move up the value chain. The international experience shows that there are a series of related problems that countries face when they try to open up new manufacturing sectors, raise productivity or move up the value chain. Of these, the most challenging is the problem of creating new productive capabilities in new sectors and technologies. This requires new ways of sharing risk and financing the adoption and learning of new technologies, and appropriate governance structures to ensure that the learning is successful. We will return to this challenge later.

Agriculture

Although the majority of our population still resides in rural areas, the share of the workforce actually employed in agriculture has fallen to below fifty per cent (see Appendix Table 1). Relatively low growth in agriculture compared to other sectors means that the share of agriculture in our GDP has steadily fallen to under twenty per cent and is set to fall further. Given the characteristics of our ecology, the problems of river waters coming from India and the highly fragmented landholding structure that precludes significant investments, it is unlikely that agriculture will play a leading

² Industry is essentially manufacturing plus utilities like power generation and construction activities.

role in driving growth or employment generation in the next fifty years. However, it is imperative that agriculture grows sufficiently to maintain food security in a world where food prices are likely to trend upwards in the next fifty years. It is also important for agriculture to sustain its growth and retain people in agricultural employment while more attractive options in other sectors are being developed. Fortunately, food output has been growing but there are significant challenges in sustaining this growth rate into the future. If manufacturing growth can be accelerated and people absorbed from agriculture into more attractive employment, the declining pressure on the land should allow land consolidation in pockets. This would make investment and mechanization easier and allow the growth of a more commercial agriculture. It is important to remember that the dominant agricultural exporting countries in the world typically have a tiny fraction of their workforce in agriculture. After a point, agricultural growth is paradoxically driven by people moving *out* of agriculture, and modern large scale farming will require significant land consolidation given the *extreme* fragmentation of landholdings in Bangladesh. These are longer term challenges for Bangladesh, and these processes will only become viable once significant job opportunities in manufacturing and high-valued services emerge.

The Service Sector

The service sector is the second fastest growing sector in Bangladesh: its share in GDP is around fifty per cent and growing. Almost forty per cent of the workforce is employed here. The service sector is particularly diverse, ranging from a modern high-value end consisting of financial services, trade, healthcare and education to a vast bottom end consisting of informal activities of all kinds including street hawkers, domestic servants and rickshaw pullers. A large part of the workforce employed in the service sector are engaged in low value activities and in this sense the service sector acts as a sink to absorb people in *some* employment when they cannot find employment elsewhere. This is the main reason why the service sector is so large in developing countries, particularly in developing countries where manufacturing is not growing rapidly enough to absorb all the people entering the job market at the bottom end of skills and education. The challenge in the service sector is to accelerate the growth of high-value service activities, and at the other end, to absorb people from low-value service activities into relatively better paying manufacturing jobs. The challenges at both ends are therefore quite closely related to the challenge of capability development. The health and education sectors, as high quality service sector activities can play a role in developing capabilities. The gaps in our education system in producing skills that are marketable are well known. But I will argue that while formal education is important it does not necessarily solve the problem of capability development required for setting up new sectors and moving up the value chain. I will argue later that on-the-job training and learning-by-doing within enterprises is vital for developing competitiveness in new sectors (Khan 2009b). In the absence of strategies for ensuring this, formally trained people coming out of the education system will fail to find jobs and their only recourse will be to migrate.

Power and Infrastructure

Power and infrastructure provision are a subset of industrial activities, but poor performance in these particular activities have resulted in their emergence as significant constraints for the whole economy. The poor supply of power and infrastructure has clearly affected growth in other sectors, as well as imposing hardships on citizens as direct consumers. At a deeper level, the power crisis is also

related to the slow progress in developing a gas and coal extraction policy that is broadly acceptable to important political constituencies. Exploration, power generation and infrastructure raise special problems because of the significantly greater chunks of capital required to develop solutions in these areas. Extracting natural resources results in a concentration of incomes in the hands of the companies who get the contracts and political acceptability requires states to have significant capabilities to tax and use these incomes to provide public goods. Our political and administrative system has not been particularly effective in addressing this problem or in dealing with the problems of rent seeking that affect sectors where significant public financing or purchasing is involved, or where significant natural resource rents are located.

Bottlenecks in other public infrastructure systems like roads, ports, bridges and so on are regularly identified as constraints by investors. As all infrastructure problems cannot be simultaneously addressed by a developing country, policy-makers have to prioritize and seek political legitimacy for their prioritization through public debate and consensus-building. In addition, specific policy and governance solutions need to be devised to address these priorities. These are problems that most developing countries face, but in our case the problem is serious enough to have significantly slowed down the expansion of supply, particularly in power generation. Waiting for 'good governance' reforms to improve accountability and transparency to address these problems is unlikely to be an adequate solution. Specific institutional and governance solutions are required that can directly address some of these challenges.

Land Policy

The fragmentation of land and overlapping systems of property rights has made land acquisition for productive purposes an arduous and difficult process. This is a standard problem across all developing countries and not by any means restricted to Bangladesh (Khan 2009a). Any significant investor requiring land for new productive enterprises has to invest a significant amount of time in locating contiguous pieces of land and then acquiring them from sellers whose own rights are often contested. Similar issues are faced by land acquisition strategies for natural resource extraction, in particular coal in the case of Bangladesh. Land acquisition by entrepreneurs often requires them to use *mastans* as 'primitive accumulators' who can use political and administrative power to overcome the problems that land acquisition faces. We know from the experience of neighbouring West Bengal that if the government does not have a strong and fair policy on land acquisition both the government and economic development can eventually face collapse. Here too, waiting for 'good governance' to sort out these problems by first creating clear property rights and then a good rule of law is not likely to be a good solution. Once again, specific developmental priorities and policies are required to make land available for accelerated development while a full sorting out of a rule of law and property rights will take a very long time. This can be partially addressed through policies like those setting up industrial zones. But the scale of the challenge implies that more specific policies are required that will work outside designated zones, and the zones themselves are proving to be quite difficult to set up and operate.

Environmental Challenges

For the sake of completeness we must add the additional challenges that Bangladesh faces as a result of the gradual global warming that is clearly taking place. As

Bangladesh contributes almost nothing to global warming, we can do very little to ameliorate this problem. If the worst were to happen and sea levels were to rise so that ten per cent or more of our land mass were lost, we would in any case be in a world where there would be significant population movements all around. Bangladeshis would not be drowning in coastal areas, they would move. So would the people in Mumbai, Chennai and possibly London. While we should certainly think about coping strategies, we have to resist a new rent-seeking game where politicians in threatened countries seek and are awarded small amounts of western aid in lieu of damages potentially caused to them by global warming. This activity diverts our attention from the real challenges of development and will not help us if the worst were to happen. On the other hand, if we can develop broad domestic competitive capabilities, our people would be able to gradually move and claim new territory to live on if the worst were to happen. In the meantime our strategy should be to grow and industrialize in the greenest possible way. There are therefore important environmental issues that we need to deal with, including assessing sustainable strategies of development, and dealing with problems of river waters and other environmental issues that are not directly connected with global warming.

This brief list of economic challenges is by no means a comprehensive one. My intention in this paper is simply to pick three areas of concern which seem particularly important to me to suggest that we need to think innovatively about implementable policy and institutional reforms. To do this we need to learn from historical experiences, and particularly from the experiences of countries that have been successful at sustaining growth and development. The strategies and solutions of other countries cannot be copied blindly because political and social environments differ across countries. Inevitably, the policy and institutional solutions that Bangladesh may evolve will be different in detail from solutions that worked elsewhere. Nevertheless, our solutions have to solve similar problems, and if we understand the problems that others addressed and solved, we are more likely to think of the solutions that may work in Bangladesh. Policy-making along these lines is clearly an involved process of discussion and experimentation, and it requires developing national awareness and constructing a broad consensus about the importance of particular strategies and policies.

While these policy and institutional challenges are difficult, Bangladesh has been at the global forefront in institutional innovations in areas such as microcredit and NGOs. We now need to focus our energies on feasible institution-building within the state that can address our pressing economic challenges. The programmes of 'good governance' and market promotion that have influenced our policy-makers in the past do not provide adequate answers to these challenges. In addition, the good governance programme is not implementable to any significant degree in the short to medium run, as the experience of the Emergency Government of 2007-09 showed in the clearest possible way. A new approach to governance and reform that addresses pragmatic problems in feasible ways is required. In this article I summarize some of the possible responses to the major challenges facing Bangladesh, and I suggest some of the governance capabilities and institutions that we need to start thinking about.

2. The Limits of ‘Good Governance’ Strategies

Governance is what states do. The importance given to governance in recent policy discussions is a welcome recognition of the importance of the state in promoting and enabling economic development. However, the contemporary understanding of governance has been largely driven by a framework of analysis that is **not** appropriate for understanding the developmental constraints faced by developing countries. This partial and sometimes flawed analysis has underpinned the support for enabling ‘good governance’. This agenda focuses on building state capacities to enforce property rights, sustain a good rule of law, fight corruption and enhance democratic accountability. While these are all desirable goals, the evidence shows that despite much policy effort and international assistance, progress towards ‘good governance’ has been very slow and small improvements that are occasionally achieved (particularly in anti-corruption) are just as frequently reversed. Moreover, the assumption that progress on good governance is a precondition for developing countries to integrate into the global economy is also flawed. The historical evidence does not support this expectation and a closer look at the theory suggests that the good governance analysis ignores some important governance challenges that confront developing countries (Khan 2006, 2007).

The international evidence strongly suggests that successful developing countries have not relied *exclusively* on market-promoting measures or on reforms that tried to institutionalize ‘good governance’ alone. While good governance identifies desirable objectives, no developing country has made significant progress on these objectives at early stages of development. As a result, high scores on good governance could not have been a *precondition* for developmental success. The prior achievement of ‘good governance’ certainly cannot explain the success of China, South Korea, Malaysia or Japan at the early stages of their development, nor of the more successful regions of India, nor our own successes in the garments and other industries. This does not mean that governance and institution-building are not important. But it does mean that we may have been focusing on the *wrong* governance priorities and trying to achieve unattainable institutional and governance goals instead of setting ourselves achievable and critical ones that are necessary for developmental success.

The reasons why market liberalization and attempts at ‘good governance’ reforms have not been sufficient for ensuring development are not really surprising. Markets and market-supporting policies are of course very important because they open up trading opportunities. Efficient markets may also help to attract investments into profitable sectors. But the problem of developing countries is that to begin with, most of the population have no capabilities to participate in competitive international markets. The competitive capabilities of both workers and entrepreneurs have to be developed and this typically requires carefully designed public-private partnerships to develop these capabilities. Economic theory suggests that *if* ‘good governance’ could be achieved, in particular if well defined property rights and a good rule of law allowed effective contract enforcement, private investors from all over the world would feel confident to come and finance capability development. They would do so in their own self-interest, arguably because wages in the developing country were lower. This argument is fine in theory but in fact we find that very few developing countries have succeeded in attracting significant amounts of foreign capital to build new productive capabilities without very specific policies (with the exception of interest in extracting oil or other natural resources). The countries that do attract

significant foreign capital in setting up productive enterprises in new sectors (like China or Malaysia in an earlier phase) did not necessarily score very highly on ‘good governance’ but did have institutions that created incentives for foreign investors and policies that ensured that these investments created national capabilities.

Without such institutions and policies, developing countries would not succeed in building capabilities, *even if they could* achieve a reasonably good rule of law and property rights. This is because private enterprise is obviously and legitimately always more interested in immediate profits and we should not expect otherwise. As a result, in the absence of specific incentives, private capital will search for countries and sectors where workers and managers already exist with ready-made productive capabilities. Private capital does not and should not be expected to take risks to develop new *national* capabilities, where the bulk of the benefit will go to the country and only partially to the entrepreneur. Economists call this type of problem an externality or market failure, and there are many such market failures that we ignore at our peril when we rely only on markets to solve problems of development. Moreover, achieving high levels of contract enforcement and stable property rights in poor countries is virtually impossible in any case. Property rights, rule of law, accountability and low corruption are ‘public goods’ that are undoubtedly highly desirable in the long run but they are not free goods. It costs a lot of tax revenue to institute systems and structures to deliver these public goods. Governments have to have significant tax revenues before they can finance the expenditures that are required to ensure high levels of property right stability and contract enforcement and other features of good governance. These desirable aspects of ‘good governance’ cannot be achieved simply because a government announces its ‘political will’ to achieve these things, or because it uses coercive force to achieve them. Our own experience with the Emergency Government of 2007-09 demonstrates this even if we ignore the experiences of other countries.

The three interdependent areas of governance which *actually* appear to play a significant role in enabling development are first, the maintenance of political stability through different forms of rent distribution, secondly, the management of difficult property right allocations to sustain growth and finally the promotion of technology absorption and capability development through learning. Successful countries used specific governance and institutional arrangements that addressed some of the important challenges in these areas. The first set of governance challenges describes the political and institutional arrangements of rent distribution through which order is maintained in developing countries. These arrangements can be more or less successful in maintaining political stability and achieving social justice, but they do not correlate very well with a simplistic extension of electoral democracy. This should not be surprising because electoral processes in poor countries do not necessarily translate into stability. One reason for this is the structural mismatch between fiscal resources and expectations. This is not an argument against electoral democracy, but rather for understanding that electoral democracy as a *process* clearly does not necessarily guarantee political stability. Stability depends much more on the organization and motivation of political parties. To what extent are dominant political parties in the country able to achieve sustainable redistributive arrangements that maintain social stability and yet allow rapid development to take place? This is clearly an important area of concern (Khan 2010), but one that we will not focus on in this paper.

The second governance capacity refers to the institutional and political processes through which property rights are transformed and transferred to emerging growth sectors in developing countries. There are wide variations in the institutional arrangements that are effective, but again, success does not correlate with a simple measure of support for the rule of law or protection of existing property rights. This too is not surprising because existing property rights are typically incomplete and inappropriate and markets are too inefficient for assets to be transferred through private contracting. Moreover, feasible improvements in the protection of existing property rights and the rule of law are not likely to reduce transaction costs to such an extent that the market can be expected to allocate resources effectively. As developing countries face serious inefficiencies in land and asset markets, the governance capabilities for resolving conflicts and assisting the allocation of assets to more productive sectors are vital. The critical governance capabilities here are institutional and political arrangements that can assist the transfer of land and other assets to growth-enhancing uses while maintaining political stability through adequate processes of compensation. The latter requires that transfers are consistent with social perceptions of justice and achieve a broad-based sharing of the benefits of growth.

Finally, a third critical area of governance refers to the capabilities of states to provide assistance to accelerate technology absorption and movements up the global value chain. There are significant 'market failures' that ensure that the natural rate of technology absorption through purely private initiatives is likely to be too slow. Even when private sector-led technology absorption does happen, it is likely to drive growth in already high capability sectors rather than contributing to the opening up of new areas. Without governance capabilities for implementing appropriate policies, employment and wages are likely to grow too slowly. These problems too are not likely to be adequately addressed by conventional improvements in the rule of law or the investment climate. Feasible improvements in these areas are unlikely to result in sufficiently efficient markets such that technology absorption and learning can be led by finance provided on the basis of private contracting. More targeted governance arrangements, policies and financial institutions are typically required and this is indeed what we find in the most successful countries and in successful sectors within developing countries (for a discussion of the underlying evidence and theory see Khan 2008b, 2009a, 2009b, 2010).

The importance of these three areas of governance explains a number of puzzles in the international evidence on governance and development. The success of dynamic developers like South Korea, Taiwan, Malaysia, or China and high-growth regions of India today, cannot be explained by their prior achievement of high scores on good governance. They would all score rather low on good governance indicators at an early stage of their developmental takeoffs. In my research referred to in this article, I look at their *developmental governance capabilities* in critical areas, and it is clear that they had growth-enhancing governance capabilities that allowed them to trigger and sustain growth over long periods. They were good at maintaining political stability, at transforming and transferring property rights to high-growth sectors without excessive social injustice or instability, and in particular they were good at creating incentives and compulsions for accelerated technology absorption. As their economies and societies transformed, they gradually began to develop the broader governance capabilities that are identified in the good governance approach, but these

were certainly not achieved *prior* to their growth takeoffs and so cannot explain the success of their economies. Secondly, this analysis can also help to explain why developing countries following the advice of international agencies and focusing on market liberalization and good governance capabilities have not achieved the same kind of success. If good governance capabilities are very difficult to attain in poor countries, and if these limited improvements make a limited contribution to the efficiency of market contracting, it is not surprising that following a governance agenda based solely on the good governance analysis has not achieved significant development success. This is regardless of the fact that many of the good governance conditions are desirable in their own right.

The three broad areas referred to above are also closely interrelated, which can explain why failure in one area is likely to eventually undermine progress on others. Political stability can only be maintained if employment and wage growth are expanding and conflicts over property rights do not result in social turmoil. Sustaining a property rights transition in turn requires a broader framework of political stability, and also requires that those who acquire rights over assets are able to use them productively by absorbing new technologies from more advanced countries. Otherwise, assets remain unproductive. If this happens, asset owners and the state may both begin to lose their legitimacy if jobs and welfare fail to improve, with implications for political stability. Finally, a strategy of technology absorption requires that investors can acquire or access *de facto* property rights over the assets and resources they require and also that there is some minimal level of political stability. Given these interdependencies, a failure to sustain technology absorption is likely to create serious challenges for vulnerable democracies in developing countries because political stability depends not just on a growing tax base but more directly on the growth of employment and wages.

In the subsequent sections, I will outline some types of immediate governance and policy challenges that need to be addressed if development is to be sustained. These examples show that the challenges facing developing countries in a competitive international environment are not going to be easy. But they are also not impossible challenges: for instance, they do not require the immediate achievement of all-round good governance or other goals that no other developing country has achieved. The latter should remain an aspiration to which developing countries should strive. But the immediate focus of policy should be to learn from the institutional and policy approaches that have actually worked in other countries to construct a number of vital institutions and governance capabilities that are likely to solve immediate development problems.

3. Capability Development and Spreading Industrial Success

The first area that I think is of great importance is the need to create broad based productive employment opportunities in society. Whatever our view of what development means, a society that fails to achieve this is unlikely to develop. By productive I mean employment that is globally competitive and therefore does not need direct or hidden subsidies to keep afloat, though I will argue that some degree of public support is initially necessary in most cases given the nature of market failures facing capability development. The problem here is that despite wages that are a fraction of those in advanced countries and despite being able to freely buy machinery

and equipment in international markets at virtually the same price as in advanced countries, developing countries typically find that there are very few areas in industry, agriculture or services in which they can achieve global competitiveness. Without global competitiveness, sustained growth in these activities is slow and uncertain not only because export opportunities are not available, but also because imports are likely to eventually undermine domestic production.

The answer to the puzzle of missing competitiveness is that low wages do not compensate for the very low initial productivity of developing countries in almost every activity including relatively low technology ones. This means that products of the right quality cannot be produced at internationally prevailing prices. Low productivity is in turn attributable to the absence of knowledge about modern production, not just at the level of techniques but also about diverse activities like managing modern factory layouts, inventory management, sales and service and so on. Simple factors like reducing input wastage a few percentage points can mean the difference between success and failure given the narrow margins on most low technology manufacturing activities. The type of know-how at issue is *not* something that is taught or can be taught in schools and technical colleges. So while overall education is highly desirable, investment in education is not on its own *sufficient* to solve the problem of low initial productivity in almost every tradable productive activity. Given the surplus of workers with formal education in the typical developing country (as evidenced by emigration across all skill categories), a focus on education may not even be *necessary* to trigger broad-based growth, though over time, the supply of workers with formal education is likely to become a constraint without investment in education. In most areas, most developing countries have an excess supply of labour: the problem is that they cannot productively employ them.

The most likely mechanism through which knowledge of actual production processes is actually learnt is through the process of 'learning-by-doing'. Individuals and groups have to continuously adapt and experiment with available technologies to achieve competitiveness given domestic capabilities, infrastructures and environments. For some activities, global competitiveness cannot be feasibly achieved given the gap in capabilities. But for many activities, competitiveness *could* have been achieved if resources and effort were put into learning-by-doing given existing formal capabilities. Learning-by-doing is not easy and many failures are likely to happen along with the occasional successes. But the occasional successes drive an economy and society forward, creating employment opportunities and helping people to rise out of poverty. The governance and policy task is to provide a supportive policy framework for learning-by-doing to take place in new sectors, together with governance capabilities to ensure that technology absorption and learning proceed at the fastest possible rate without resources being wasted. Technologies are effectively absorbed if productivity growth increases sufficiently for production with a particular set of equipment to become globally competitive. Once this happens, that particular technology can be more easily replicated across society by workers and managers migrating to other firms and taking their tacit knowledge with them, managers setting up their own firms, and so on. This significantly shortens the learning times of other firms and accelerates the development of clusters of similar firms.

The policy challenge is to understand why this does not happen more frequently in developing countries. At its heart is a financing problem: effectively a period of risk

and loss-making has to be financed while the learning is taking place. In theory this period of loss-making could be financed by private investors because the eventual stream of profits should more than compensate for temporary periods of losses. But private financing is the exception rather than the rule and private investors have demonstrated extreme reluctance in financing technology absorption in developing countries. In contrast, and for obvious reasons, private investors have been very keen to invest in sectors and activities where a developing country already has competitive advantage. A number of reasons have been put forward to explain why private contracting is likely to be inadequate for the development of new sectors and capabilities. These focus on different types of ‘market failures’ (for a review of different models see Khan 2009b). These include ‘big push’ arguments that say that learning in one sector is unlikely to succeed without simultaneous demand expansion across a range of related sectors (Rosenstein-Rodan 1943; Murphy, et al. 1989). The argument here is that competitiveness and profitability depend on other domestic sectors creating demand for the products of this particular sector. But as markets are not limited to domestic ones, this does not offer a sufficient explanation for why a number of export-oriented sectors do not sequentially develop in these countries.

A more recent explanation is that globally competitive sectors have to be ‘discovered’ by entrepreneurs, but entrepreneurs who take the risk to discover these sectors face rapid imitation by newcomers and the new entrants (it is argued) rapidly reduce the rents (high profits) that the initial entrepreneurs expected (Hausmann and Rodrik 2003). This appears to be a plausible model but it has a number of flaws. It assumes that countries have implicit comparative advantages for producing certain types of products and entrepreneurs have to discover these. This is not a plausible hypothesis. It is unlikely that some population groups have an innate advantage in making bed-sheets while others are innately good at making hats in the way that Hausmann and Rodrik suggest in their comparison of Pakistan and Bangladesh. Moreover, in most types of export-oriented activities in developing countries, new entrants are not likely to reduce the profits of the initial entrepreneurs. Global markets have prices for most products that are unlikely to shift as a result of a few more new entrants. Moreover, wages are very low in developing countries and likely to remain so because of large pools of unemployment. New entrants in a particular sector, even a labour-intensive one like garments and textiles are unlikely to absorb so much labour that wages begin to rise significantly simply as a result of imitation. So if investments in discovery are low it must be that entrepreneurs are risk averse anyway, not that they are prevented from investing because of their fear of declining profitability due to the entry of others later on.

A more plausible explanation that is consistent with the observed facts of technology acquisition in developing countries focuses on the role of financing and the enforcement of contracts. If achieving competitiveness and profitability requires learning-by-doing, then a period of loss-making has to be financed when new sectors or upgraded technologies are first introduced. The problem is that loss-financing by itself does not ensure that the learning will take place at the fastest rate, because learning also requires significant *effort* by managers, workers, suppliers and others and this collectively determines the competitiveness of the production process. If effort is insufficient, financiers can lose their money as the accumulation of losses can make the project unviable. Here, the overall context of a weak rule of law and weak contract enforcement is indirectly relevant. If contracts *were* enforceable and could

protect the interests of investors, this *may* induce more of them to invest in projects involving significant learning. In principle, therefore, the argument that an improvement in contract enforcement *could* enhance investment in developing countries is theoretically plausible. But in practice a significant improvement in the rule of law and contract enforcement is not achievable in the short to medium term. This is why different types of public-private partnerships that implicitly shared the costs and risks of investing in new areas played a significant role in the catching-up processes of developing countries. But for these arrangements to work, appropriate governance capabilities had to exist to ensure that the support was not wasted. High levels of effort are only assured if the opportunities created for learning are accompanied by limitations on the period of support, or even better, if they are associated with performance monitoring during the period of support and credible mechanisms of withdrawal of support if performance is unsatisfactory.

Case studies of successful technological upgrading and the emergence of new sectors in developing countries show that loss-financing through different mechanisms was very important for enabling investments. But success also required that the financing came with credible incentives and compulsions that ensured high levels of effort. This is supported by case studies that I have studied of industries in Thailand, India, Bangladesh and other countries that achieved global competitiveness even in the period of global 'liberalization' after 1980 (Khan 2009b). The ambitious industrial policy strategies characteristic of the East Asian developers achieved limited successes in many countries because their political contexts did not allow the centralized disciplining of subsidy recipients that was necessary to ensure high levels of effort. Many countries including India, Bangladesh and Thailand began to abandon ambitious industrial policies in the 1980s as a result. The problems of learning and achieving competitiveness in new sectors did not disappear, however, but now more sector-specific solutions emerged. The solutions were sometimes planned but were often unplanned results of policies that sometimes created appropriate incentives and compulsions for learning with high levels of effort. The mechanisms and governance arrangements that achieved successful results varied significantly across countries and even across sectors and regions within the same country. But the general feature that successful sectors shared in common was a combination of a period of loss financing and credible incentives and compulsions that ensured high levels of effort.

The best way to discuss the importance of financing learning processes is to recall our own experience in Bangladesh. Bangladesh has enjoyed high growth in manufacturing driven by the spectacular success of the garments industry since the 1980s. To some extent this success has been helped by the fact that Bangladesh has some of the lowest wages compared to its competitors and even today has one of the lowest labour costs per hour in the global garments and textiles business. But even with its labour cost advantage, Bangladesh did not break into the garments business without a number of critical financing accidents that allowed it to build the capabilities that started the industry off on its road to success. The story is extremely important for us because it shows that even a labour-intensive and apparently low technology activity required a period of learning and capability building. Moreover, it is unlikely that this learning and capability building would have been entirely financed by private investors in the absence of the very fortunate implicit financing that became available as a result of a fortunate conjuncture that involved the Multi-Fibre Arrangement (MFA).

The growth of the ready-made garments industry in Bangladesh has often been presented as a vindication of the success of free market policies combined with the virtual absence of labour market protections in Bangladesh. A closer look at the history suggests that in fact investment even in the simplest of technologies involves significant risks for domestic investors when these technologies are new to the workers and managers in the economy. The time it will take to become globally competitive cannot be known in advance and entrepreneurs have little idea of what is required to achieve competitiveness in new and very specialized globalized production networks. Nor is it viable for foreign firms to invest in up-skilling labour in a poor economy in low-margin, low technology industries unless there is some cost-sharing and risk-sharing for the foreign firm. This is of course why a significant part of global production does not immediately shift to poorer countries. To understand the garment sector takeoff in Bangladesh, we have to look at the special and fortunate combination of factors that enabled the transfer of globally competitive garment producing technology to Bangladesh in the early 1980s.

An important component of this fortunate conjuncture was the emergence of the Multi-Fibre Arrangement (MFA) of 1973. This was an arrangement administered by the General Agreement on Tariffs and Trade (GATT). MFA set bilaterally negotiated quotas on developing countries for textile and clothing exports primarily to satisfy US objections to free trade with garment producing countries which threatened the domestic garment and textile industry in the USA. As a concession to global opinion, the MFA did not put quotas on a number of least developed countries like Bangladesh which did not have any garment industry at the time and were therefore no threat to the US (Goto 1989). The MFA implicitly created 'quota rents' for Bangladesh because quotas meant Bangladesh had the privilege of beginning to produce garments even though it was not the least-cost producer and would not have succeeded in a free market to compete with existing producers despite its lower wage. This implicitly created incentives for countries like South Korea to support the setting up of garments production in Bangladesh so that they could at least export their fabrics. This allowed the 'doing' to start in Bangladesh, but the 'doing' does not necessarily result in 'learning' unless other conditions create compulsions to actually put in high levels of effort and achieve international competitiveness quickly.

Bangladesh was additionally fortuitous in having some of these other conditions as well in the emerging garments sector. Just at that time a potential investor class was emerging through the 'primitive accumulation' that took place after independence in 1971. This new class of investors had money and were looking for productive activities in which they could invest. They did not expect to continue to make money through primitive accumulation unless they could become competitive in international markets. When the first garment factories began production in Bangladesh and started making profits rapidly by successfully engaging in the learning process, other potential investors rapidly understood the viability of investing in learning in this sector. They were further helped by the availability of managers and workers in the already successful firms who could be poached easily. And finally, Bangladesh at that time had an 'investor-friendly' leader in the form of President Zia who saw the importance of underwriting foreign investments in the sector using informal support at the highest level. It was the concurrence of these favourable factors that enabled private investors to take risks to build new capabilities in Bangladesh, and they took

these risks because these lucky factors significantly reduced the risks that would otherwise have constrained capability development.

The capability development process in the garment industry began with the collaboration between a retired Bangladeshi civil servant turned entrepreneur, Nurul Quader Khan, and a South Korean multinational, Daewoo. The Bangladeshi entrepreneur set up Dosh Garments in 1979 and provided all the capital for the investment in plant and machinery. The government provided vital support by promising supportive policy changes for a potentially risky investment. The critical part of the story is that the South Korean multinational provided the training and technology transfer upfront (thereby financing the learning), with their outlays to be recovered as a percentage of the future exports of Dosh. The South Koreans hosted around 130 Bangladeshis at their plant in Pusan, teaching them not only how competitive garments production was organized but also giving them a hands-on idea about factory layouts, the pace of work, quality control and so on. If we look at the incentives of the different parties in this arrangement, we can see why everyone had strong incentives and compulsions to put in high levels of effort into the learning and capability-building process. Daewoo had strong incentives to push the training process and to transfer knowledge and capabilities to the visiting Bangladeshis because this was the fastest way to recover their investment. The Bangladeshis had strong incentives to learn because hanging on in Pusan was not an indefinite option and returning without the capability would ensure that they and the firm would not survive.

The quota protection was important not only for inducing Daewoo to look for offshore manufacturing processes that could use its fabrics. It also reduced the competitiveness gap that Bangladesh had to climb. It still had to engage in learning to be able to export, but the narrower gap made it credible that the Bangladeshi company would be able to quickly pay back the up-front investment of the South Koreans in training the visiting Bangladeshis. In a quota-constrained export market, Bangladesh would only need to make a more limited improvement in its productivity to become globally competitive, and this significantly reduced the risks for the private entrepreneurs investing in capability development. The fact that there was a Bangladeshi entrepreneur willing and able to make the upfront investment in plant and machinery also reduced the risk for Daewoo because it established the commitment of the Bangladeshi firm to the success of the project. In addition the president of the country credibly promised that a small number of critical institutional changes would be made effective very quickly and this further reduced the risks facing the achievement of competitiveness by Dosh. Explicit support was provided to the project by President Ziaur Rahman. The President had taken the initiative in the first place in linking up Nurul Quader with Kim Woo-Choong, the chairman of Daewoo. He also assured the South Koreans that unexpected problems would be dealt with or at least addressed. And in fact, political support at the highest level assured the South Koreans that relatively small but critical institutional innovations like the back-to-back LC (which allowed Bangladeshi producers to borrow from local banks using export orders as collateral) and the bonded warehouse (which allowed complex customs duties on imported inputs to be avoided) would be quickly introduced.

Dosh was remarkably successful. Between 1981 and 1987 its export value grew at an annual average of 90 per cent (Rahman 2004). The learning and transfer of

technology that was unleashed by this single project was remarkable. By the end of the 1980s, of the 130 people who were first trained by Desh in Daewoo's factories in South Korea, 115 became entrepreneurs and set up their own garment firms (Rhee 1990: 341). This apparently did not do much damage to Desh, whose output continued to grow at close to one hundred per cent per annum during this period. The loss the company suffered when it lost a manager was made up many times over by the high levels of effort that these individuals invested in the first place as a result of this implicit incentive. Afterwards, normal market competition took over and the migration of skilled workers and managers worked to create an industrial cluster that attracted buyers and created its own beneficial dynamic to drive growth in the sector. From virtually a zero base in 1980, by 2005 there were around 3500 active firms in the garments sector directly employing well over two million people (World Bank 2005). Primitive accumulation continued to be an important source of entrepreneurial supply. In a survey carried out in 1993, 23% of garment factory owners responded that they had originally been civil servants or in the army (Quddus and Rashid 2000). We can assume that many others had close contact with politics and had made their initial capital through political processes. From a country not much different from the typical African country in the 1970s, Bangladesh's manufacturing output today equals that of all of sub-Saharan Africa combined excluding South Africa.

The rapid emergence of Bangladesh as a garment exporting country is shown in Table 4. Exports grew at double digit rates for more than two decades. By the early 2000s, the sector accounted for around 70% of Bangladeshi exports. By 1985, such was the success of the Bangladesh garment industry that Ronald Reagan negotiated quotas for Bangladesh under the MFA (Rashid 2006). Bangladesh has continued to benefit from preferential treatment, particularly in European Union markets, but effectively, the first five years of quota protection were enough to trigger a major shift in the country's technological capabilities and therefore its manufacturing fortune.

Table 1 Bangladesh Garments: Growth Rates of Dollar Exports 1985-2006

Year	Woven	Knitwear	Total Garments	Dollar Export Growth Rates
1985-1990				45.9
1990-1995				24.1
1995-2000				14.3
2000-01				11.7
2001-02	-7.1	-2.5		-5.7
2002-03	4.3	13.3		7.2
2003-04	8.6	29.9		15.8
2004-05	1.7	31.3		12.9
2005-06	13.5	35.4		23.1

Sources: (based on Mlachila and Yang 2004: Table 1; World Bank 2005: Table 1).

The experience of Bangladesh in setting up its garments industry is not unique. A very similar story can be told for other important sectors in developing countries, like the automobile and pharmaceutical sectors of India and the electronics industry of Thailand (Khan 2009b). In all these cases, the initial capabilities that allowed a major industrial takeoff in a sector were developed because some 'non-market' source of

implicit financing was available that reduced the costs and risks of capability development by private investors. But these breaks only worked if the institutional and incentive structure ensured that the entrepreneurs and workers getting the privilege of building capabilities felt strong compulsions for putting in high levels of effort to achieve global competitiveness relatively quickly. When public-private partnerships or indeed industrial policy protections and subsidies provided opportunities for learning *without* the compulsion for companies to put in high levels of effort, the exercise typically failed and the financing was wasted.

The challenge for Bangladesh as we try to create new sectors, or even to assist the garment and textile industry to move up the global value chain is to create the appropriate new capabilities. In each case, private sector investors face significant risks and uncertainties because the required capabilities do not exist and investment in capability development can be very slow without financing arrangements that reduce the risks of investing in new capability development. The combination of incentives and compulsions that worked in the early stages of the garment industry with MFA cannot be reproduced in other sectors. Indeed other sectors will have different technologies, different issues with capability transfer, different opportunities for financing, and different global market conditions. As a result, the governance and financing solutions will inevitably be different.

If we go to the core of the issue, fully or partially financing an initial period of loss-making when new technologies are being learnt is one of the important requirements for start-ups even in new sectors, even if they are low technology sectors like garments. In principle, markets should enable the learning to be financed but there are significant market failures because uncertain periods of learning expose investors to levels of risk that are often too high given the narrow margins in these established sectors (Khan 2000, 2009b). Our experience in the garments industry has implications as Bangladesh attempts to move higher up the value chain. Much of its growth so far has been at the lower ends of the value chain, even though there is evidence of growing backward linkages and diversification. By 2005, roughly 45% of export value was added in the domestic economy due to growing backward linkages in spinning, weaving, dyeing and accessories (Bhattacharya, et al. 2002; World Bank 2005; Ahmed and Hossain 2006). But our survey of the garment sector in 2007 revealed that the available types of financing were an important constraint to technology upgrading in the sector (Khan 2008a). Banks were willing to lend to investors in the garment sector but the interest obligations and collateral requirements deterred investors in new sectors and technologies who were not sure about the length of time learning would take. A small delay in achieving global competitiveness with interest piling up could make a major project unviable. This is despite the fact that bank funding in general was not scarce and established investors had no difficulty in borrowing significant sums for projects where they already had capabilities to be globally competitive. This explains the rapid horizontal growth of the garments industry, and the relatively slow progress up the value chain, and the relatively slow progress in industrial diversification. The aim of policy must be to accelerate our move up the value chain as well as to support new industrial clusters like electronics, pharmaceuticals, shipbuilding and machine tools with appropriate financing arrangements to accelerate learning processes.

The obvious conclusion must be that a more rapid expansion of learning has to be based on creating new financial institutions that specialize in providing term finance at attractive interest rates for start-up companies in new sectors and sectors where we want to promote new industrial clusters. But these financial institutions have to have carefully designed governance and incentive structures to replicate the incentives and compulsions that resulted in high levels of effort in sectors like the Bangladesh garment industry. Specialized financial institutions that are set up for this purpose are only likely to do this if governance capabilities are also developed to support these types of lending. For instance, given that the rule of law and contract enforcement are not well developed in general, it will be necessary to develop specific governance agencies and capabilities that focus on regulating and enforcing loans designated as start-up loans for new sectors. And given the limited reform capabilities and skilled personnel in developing countries this also implies that these types of *developmental governance capabilities* need to be identified as national development priorities.

This is an important observation as development financing institutions played a negligible role in financing new learning and capability development in the period after the 1980s. Banks have played an important part in driving the industrial growth of Bangladesh, but they have typically played a major role once the difficult task of capability development and learning had already been financed and achieved through other processes. Normal commercial banks lend against machines, land and assets, but loss-financing during learning is not backed by assets. It is backed by the organizational capital of an organization, and the value of this depends on the effort the organization puts in. Development banks were supposed to finance the building of new productive organizations but stopped playing a significant role in the 1980s with the demise of industrial development banks like the Shilpa Rin Shangstha and Shilpa Bank in Bangladesh. Similar banks in many other countries also performed rather poorly because they failed to achieve the internal governance structures that could provide strong incentives for ensuring high levels of effort amongst their borrowers. To design financial institutions that can effectively finance capability development better in the future, we need to properly absorb insights from the success of particular sectors like the garment industry which enjoyed a period of implicit financing through accidental devices like the MFA. The incentives and compulsions that induced high levels of effort in these successful industries need to be replicated in the operational and governance procedures of new development finance institutions.

The most important lesson from these experiences is that financial instruments that can assist learning can only be successful if the instruments are designed and governed to induce high levels of effort in capability development. Most important, a lot of attention has to be given to designing the governance and management of these institutions if they are to have the appropriate effect. It is better to start on a small scale, experiment with the design of the institution and the financial instruments and the governance structures that it uses, and then scale up gradually with experience. The need to ensure high levels of effort on the part of the enterprises being financed to develop new capabilities is of paramount importance. High collateral requirements (which is the route followed by commercial banks) are *not* an effective way of ensuring effort on the part of borrowers because the risk and uncertainty of investing in learning and capability development means that private investors will not borrow significant amounts backed by their own collateral for *capability development* projects. This is precisely the market failure that we have to address. On the other

hand, loans without adequate collateral also have poor effects and can lead to low effort and wastage unless banks have strong internal governance structures of monitoring and withdrawing capital from poorly performing projects.

Alternatively, innovative financing instruments can be experimented with such as providing finance through equity holdings. But these also have problems if they are not well designed. An example is the Equity and Enterprise Fund that is already in operation in Bangladesh to promote new start-ups in new areas. This is a good idea in principle but as a financial instrument to promote learning it has not generated much success so far. Its limitations can be traced to its design, and is related to the insufficient incentives and compulsions for enterprises to put in sustained high levels of effort (Khan 2008a). For instance, if the equity financing instrument allows entrepreneurs to survive without making or fully declaring their profits, not only does the financing institution fail to get a return on its investment, more importantly, the enterprise may not perceive any great compulsion to improve its capabilities. Moreover, if procedures for capital withdrawal from unsuccessful ventures are not very credible, the pressure on the enterprise to put in high levels of effort will be even lower. By looking more closely at the drivers of successful capability building in Bangladesh and elsewhere, financial institutions and instruments can be much better designed to accelerate capability development appropriate for setting up new sectors and industrial clusters.

There are many ways in which we could begin to address some of the incentive and governance problems facing the financing of capability development. In an export-oriented industry, the value of exports is difficult to hide. As a result, financial institutions can get a fair return and create incentives for the firm to put in effort if the return on the 'equity investment' was linked to export earnings. If this was combined with a time bound equity investment which could be withdrawn if minimum export earnings were not achieved within a predetermined number of years, a viable combination of incentives and compulsions could be achieved for investors which would not impose excessive risk on them, but would also create compulsions for effort. But these conditions are only likely to have the desired effect on capability development in new sectors if entrepreneurs believe that the rules are enforceable. This in turn requires that the development finance institution is recognized as a national priority and gets non-partisan support from the political leadership to achieve its developmental goals. A generalized rule of law is too ambitious for a developing country, but a commitment from political leaderships to construct one or two relatively small institutions that will drive critical national goals may be achievable if the importance of these institutions is widely understood. After all, there are one or two institutions that work relatively well in any country. In Bangladesh, for example, the central bank is an institution that works reasonably well. The point is to be pragmatic and identify a small number of additional vital institutions that need to be built.

4. The Political Economy of Land and Natural Resources

Conflicts over land and resources are an important and occasionally fatal constraint that can hit developing countries if they do not take adequate preparations in time, with the requisite political participation. If we look at our own slow progress in developing an effective Coal Policy, our difficulties in giving gas exploration rights to

foreign companies in a transparent way, and our difficulties in setting up industrial zones, the importance of this point will probably not need much stressing. The neighbouring state of West Bengal in India has gone into another phase of deindustrialization after the debacle at Shingur, largely because the ruling party mismanaged land acquisition issues and gave an opportunity for the opposition to play populist politics to block industrial land acquisition at Shingur and elsewhere (Khan 2009a). There are many negative lessons to learn from India about how the failure to institute broadly legitimate processes of land acquisition can result in very serious social costs and even the blocking of development processes. In India, rapacious land grabbing by real estate businesses and other speculators, together with the often forceful evictions of tribals by mining companies led to not only a violent Maoist backlash, but also to strong internal opposition to investments that required land acquisition. In a big country like India, the blocking of development in a few states and even a massive Maoist insurgency still leaves large areas that can go on driving growth. However, were anything like that to be unleashed in the smaller territory of Bangladesh, we would be in very serious trouble. Bangladesh is a few years behind India in terms of the scale of land acquisition for new industrial and mineral development, and we clearly need to start building political and institutional arrangements to avoid the crisis that is already gripping many parts of India.

The critical point about the political economy of land and resources in a developing country is that good governance and clear property rights on land and resources will not and cannot address this problem. We have already discussed why progress towards 'good governance' is likely to be painfully slow in developing countries, but in no area is this more apparent than in the political economy of the property rights transitions that developing countries go through (Khan 2009a). Developing countries that manage to navigate their way through the property rights transition with less social upheaval and resistance are not necessarily countries with better scores on good governance. Rather, they are countries that spent time and resources building a few institutions and the political consensus behind it to achieve the necessary allocations of assets and resources with the greatest degree of social fairness. This requires in particular the development of compensation arrangements that make sense and that are not captured by clientelist politicians. It is also important to ensure that the benefits from development are shared between investors and the broader society.

Here too what works in different countries clearly depends very greatly on the political arrangements that exist within them. Even within India there is a very significant difference in the land acquisition and compensation policies across states, as well as in the degree of administrative control that different states have over land acquisition and allocation issues. This is not the place to review these variations in the historical experience, though the reader may refer to Khan (2009a) for a discussion on these important cross-country and cross-regional differences in the political economy of land and property right management. The only point that needs to be made is that we need to prioritize both institution building and the construction of a political consensus on the importance of resolving these issues in viable ways. The tendency in poor countries is for the partisan allocation of land and natural resources as the ruling party can allocate these resources to strengthen its political constituency. To some extent this is unavoidable. But it is also important for political parties and movements to initiate public discussions on these issues by setting out their own principles. How should national resources be best used (for instance, to maximize revenue for the

taxpayer or to maximize broader national development)? How should land for industrial expansion be acquired in places where land is very fragmented and property rights are not clear (which means that investors attempting to acquire land purely through the market will face very high transaction costs)? What should be the principles of compensation and who should be compensated (owners, residents, users of land or all of the above)? Do the principles of compensation change depending on the type of investment planned (natural resource extraction, real estate, infrastructure development or industrial investment)?

It may be very plausibly argued that raising these issues will politicize an already politicized area and is not likely to bring great benefits for the policy-makers raising these questions. I cannot disagree more. The failure of our political parties to engage in high-level policy discussions on these issues and to evolve some semblance of a national consensus has resulted in an almost total logjam in developing our scarce fossil fuel resources and has created obstacles for developing new industrial zones and new infrastructure such as roads. As the pressure on resources brings forward informal and ad hoc solutions, typically involving very partisan decisions by ruling parties, the unresolved political questions are likely to hit us in the form of popular resistance and social turmoil as they have in other countries. Muddling through and ‘managing’ may be an option at very early stages of development, but as the scale of development increases, we are likely to be suddenly hit by intense social resistance in a densely populated country if institutional and political capacities to address issues of land and resource management are not built up.

Responsible political leadership should take the first steps to raise difficult questions, set up high-powered groups of policy-makers to suggest policy guidelines and institutions to handle these questions, and then test these ideas through broader national debates in the media. There are no right answers, but there are better and worse ways of doing these things, solutions that are more or less fair, and most importantly, solutions that are likely to be more or less acceptable given the political context of the country. It is imperative that if political parties want to promote rapid development, they should do their homework in preparing plans for a small number of high-powered institutional structures to address these issues and then create the political awareness and support base amongst important constituencies for the strategies of land and resource development that are being advocated.

5. Accelerating Power Sector Investments

The crisis with the painfully slow expansion of power generation capacity involves many of the political economy constraints affecting Bangladesh. Once again, without pragmatic steps that address some of these issues, progress is likely to continue to be very slow. The political blocking and lack of transparency in the power generation sector are well known. The standard response has been to focus on poor governance and institutional capacities in the sector, which are in general hard to refute, but I will argue that attempting to address these problems using ‘good governance’ reforms like attempting to improve transparency and accountability are not likely to yield quick results. Indeed, some of the issues of poor transparency and accountability are themselves the results of deeper problems. Again, pragmatic steps can weaken some of these constraints and political leaderships need to start working in earnest to identify the points of entry and to work intensely at these points. Business as usual is

not working. In particular, many of the problems that we face arise from a huge discrepancy between the cost of producing power, which partly depends on the high costs of financing these huge investments, and the effectively subsidized price at which the PDB is bound to sell power given the purchasing power of the retail customer and the need to accelerate small and medium industrial investments. The result is an increasing financial deficit that is facing PDB, and the fear that this may not be sustainable further raises the risk premium that is added to the cost of financing investments in this sector. The result can be a particularly unfortunate vicious cycle where the risk premium raises the cost of generating power, and the higher cost of additional power further strains PDB finances, further raising the risk premium for subsequent projects.

Let us begin with a specific feature of the power generation sector in Bangladesh that sets it apart from many other developing countries. The share of the private sector in electricity generation is already high (relative to our neighbours), and current plans are to significantly increase this share. By 2010 the private sector generated 38% of electricity in Bangladesh. In comparison, in 2008-09 the private sector in India generated less than 15% of India's electricity. The Government of Bangladesh elected in 2008 announced in its 'New Initiative' plans to attract an additional USD 9 billion of investment in power generation by 2015, of which USD 8 billion is expected from the private sector. *If private investment on this scale were achieved*, this would raise the share of the private sector in power generation in Bangladesh to around 65% of total generation capacity according to government figures. Thus, the plan aims for a significantly higher share of private investment in generation compared to India even though the latter is much more advanced in terms of international interest in its infrastructure sector. But I believe private investment on this scale is very unlikely to be forthcoming given the risk characteristics of this sector unless governments take specific steps to address some critical issues.

Possibly the most important critical issue here is the implication of such an expanded role for the private sector for the risk premium facing private investments. Power plants with the capacity to generate a few hundred megawatts involve significant investments upwards of several hundred million dollars with plant lifetimes of well over a decade. Private sector investors investing in these projects aim to sell electricity to the government which typically has to buy the power at a higher price than it is feasible to sell to final consumers. The difference appears as a deficit in the PDB's accounts which is ultimately met by transfers from the central budget. The private producer's contract with the government is for the cost of power generation net of the input cost of fossil fuels. Holding the fossil fuel price constant, the subsidy to private producers is higher the higher the private generation cost and the total subsidy grows with the total volume of electricity purchased. Unfortunately, the generation cost is not independent of the total subsidy that the government has to finance, because as the total subsidy increases the risk of PDB insolvency increases. This raises the risk premium for private financiers and thereby raises the cost of generation. While contracts with a government may appear 'watertight' on paper, the underlying risk of a future default cannot be adequately insured against and there is therefore a non-negligible risk of government default or (more plausibly) a renegotiation of contracts in the future. This results in an implicit risk premium in raising finance for these investments. Unless the government is very careful in controlling the cost of finance and the risk premium, investment in the power sector

can suffer from a vicious cycle of causation that can slow down or even preclude significant productive investments.

High financing costs have a number of important effects for investments in this sector. Indeed, the cascading and possibly self-fulfilling effects of high risk premiums partly explain why the public sector or at least public financing has historically played an important role in the power sector in developing countries. Both the public sector and state-assisted financing for the private sector continue to play this role in India despite the significant opening up that has happened in that country. The market failures that prevent full contracting mean that the public *financing* of power sector projects may be more efficient even though power is not a pure public good. In particular, in very poor countries, private risk perceptions and risk premiums may make the price of private power generation considerably higher than would otherwise have been the case. To accommodate this, the levels of government subsidy required may rise significantly and be ultimately unsustainable. Already by FY2009, the monthly subsidy to PDB had been formalized at 500 million taka and will grow probably five-fold if the projected private sector investments come through. Not only is this likely to be unsustainable, but these figures are based on current production costs being sustained. In fact, the increasing risk premium as the market adjusts to successive increases in subsidy is likely to result in higher costs of production for successive plants and therefore a higher required subsidy.

This characteristic of power generation financing can help to explain a striking feature of bidding for private power generation contracts in Bangladesh. These tenders generally attract very limited global interest and usually a very small number of players with close relationships with government remain at the final stages of bidding for significant power generation projects. Typically, the limited number of bidders is taken as evidence of limited transparency and the high costs and uncertainties of bidding. This is partially true. But given the high levels of risk that cannot be effectively contracted against, it is not surprising that only firms that have already invested heavily in relationships with individuals in positions of power are likely to risk proceeding to the final stages of the bidding process.

The private investor knows that whatever the contract says, in potentially adverse future conditions the contract may be difficult to enforce and there are many unknown and therefore non-contracted risks that can also affect the overall viability of the investment. As a result, it is rational for firms to invest in 'relationships' with government to mitigate these risks by keeping open preferential and personalized channels of negotiation that allow ongoing informal contracting. In case of future difficulties with payments or access to fuel, investors know that contacts and informal bargaining are more likely to be important than contracts and formal processes of redress. Given the high cost or even implausibility of enforcement through the formal legal system, firms are more likely to be able to negotiate any required changes on an ongoing basis, or to ensure that they will be higher up the chain of claims in case of financial difficulties if they can call on long-term relationships with politicians and bureaucrats in critical positions. This is not a sufficient guarantee because politicians and bureaucrats will certainly not remain in place for the lifetime of a power project, but it is unlikely that firms will even begin to engage in this sector in the absence of these relationships.

Just as important, close links to government can give bidders who are close to the government access to low cost government financing through the back door by enabling them to organize part of their financing from public banks, institutions and funds. However, these conditions may later be interpreted as collusion and corruption that further increases the risk for investors because contracts are likely to be re-examined by subsequent governments if new relationships with the subsequent government are not rapidly established. And while there are 'legitimate' reasons why only firms and individuals with established relationships with government and bureaucracy will bid for projects, these conditions also enable damaging collusion. For instance, technical specifications can be set to privilege suppliers associated with particular insiders. Ironically, even if a firm resists capturing additional advantage using its relationships, it is very difficult to signal to the general public or to subsequent governments that they did not seek special privileges. Firms therefore have every incentive to seek privileges and have money on tap to make deals with politicians. This argument is not intended to excuse the corruption and collusion of participants in power sector projects, but to demonstrate that this type of corruption is unlikely to be addressed using standard anti-corruption tools such as greater transparency in the award of contracts. The personalized relationships here are not the result of limited transparency. Rather the limited transparency is a result of the relationships that are required to sustain investments in a context of risks that cannot be contractually limited.

The problem is if investors know that the only way they can bid at a reasonable price is if they are close to the government, they also know that subsequent governments may take an adverse view of their business. Under these circumstances, there is unfortunately a strong incentive to make money quickly rather than to risk being exposed to future challenges by a subsequent government. These features of the power sector can explain some specific characteristics of the power sector in Bangladesh. Irregularities in the power sector are a characteristic of every developing country, but in Bangladesh rent capture happens mostly at the procurement stage as opposed to the production or distribution stage. Procurement irregularities have resulted in persistent problems with external funders like the World Bank about appropriate procedures and transparency. Rent capture at the procurement stage often also means that technical specifications are tailored to ensure that bidders preferred by particular insiders are favoured, or specifications are deliberately set to be very demanding to raise prices of outsider bidders while insiders can expect lax monitoring of specifications. This suggests that in Bangladesh even firms with significant relationships with government do not wait for long-run profits based on power generation and are more likely to seek to capture significant rents at the procurement stage.

It makes a lot of difference whether private sector firms seek to make high profits at the procurement stage by overstating the price and quality of the capital equipment or at the production and distribution stage, for instance by influencing the price at which power is purchased. The former creates significant upfront rents at the very inception of the project, while the latter can create a stream of somewhat more modest rents but throughout the lifetime of the project. The latter may add up to be significantly higher in aggregate, but if investors doubt the future solvency of the government as the purchaser of electricity, they have strong incentives to make as much money in the procurement and installation stage of the project. The rational investor, particularly

the local sponsor who may be more aware of local political economy, is therefore likely to want to make as much of their return as possible upfront and rely less on the stream of future incomes for guaranteeing an overall return on investment. This could explain the strong preference in Bangladesh for maximizing ‘procurement rents’ as opposed to rents on production and distribution. The rents that investors seek have implications for the likely outcomes. A focus on procurement rents has particularly adverse implications for the quality of projects and the real cost of generating power.

When we look at these interrelated factors, it is not surprising that there have been remarkably few major successes in private power projects so far. In fact, there have been no significant private investments in power generation since the Haripur and Meghnaghat investments that became operational in 2001 and 2002 respectively. In both these cases, the cost of capital was significantly reduced as a result of financing by international development finance institutions. In the case of Meghnaghat financing was provided through IDCOL (the Infrastructure Development Co. Ltd.) a bespoke financing company that received significant funding from the World Bank and the Asian Development Bank, and indirectly in the case of Haripur through the provision of a Partial Risk Guarantee by the World Bank. The financial viability of these projects and the credibility of the government’s power purchase agreements meant that effective procurement processes could be enforced in both cases. In both cases the cost of power generation was relatively low, and comparable to the average public sector generation costs. The success or otherwise of the New Initiative of the Awami League government depends on whether the half a dozen or so power sector project contracts that were awarded by 2011 to a single private sector company (Summit Group) can actually be delivered given the financing and credibility problems discussed earlier.

The longer term challenge for Bangladesh is to multiply power projects on this scale every few years, and that requires attention to the longer term issues, regardless of what happens to the Summit contracts. Common policy responses to the slow pace of investments in the power sector have usually focused on fixing characteristics that diverge from the ‘good governance’ and competitive market models. For instance, development agencies including the World Bank have insisted on transparent procurement guidelines and bidding procedures. However, these reform efforts have not yielded significant results. This is partly because our analysis suggests that many of the characteristics that are targeted are themselves the outcomes of deeper causes. For instance, the existence of a small number of bidders and evidence of irregularities at the procurement phase may appear to be the result of poor procurement and bidding procedures but may actually be manifestations of deeper problems associated with high risk premiums and contracting costs in contexts of structural uncertainty. Given this general context, it is not surprising that rule-following procurement and bidding processes have not emerged nor have political parties become more accountable to the extent that they are able to make transparent decisions in the public interest.

This analysis suggests that a more pragmatic way of breaking some of these constraints would be to ask if the credibility of a flow of power sector projects can be increased. Here, there are some interesting comparisons we can make with the Indian experience. By ensuring a *public sector* flow of funds that could finance a significant stream of power projects, the logjam over contract awards and the focus on procurement rents was avoided. This does not mean there is no rent capture in the

Indian power generation sector: there is, and it is significant. But by changing just one of the independent variables, India achieved significantly greater power generation per capita compared to Bangladesh. A few facts here will put the problem in Bangladesh in perspective. In 2007 India's per capita consumption of electricity was 714 KWh compared to 155 KWh in Bangladesh (World Development Indicators 2010). India's current installed capacity is 143 GW but it too suffers from a serious power deficit and Indian policy-makers believe that to sustain its economic growth it has to add another 100 GW of capacity by 2012 (Altaf 2009). This is not only a challenging prospect but also suggests that given India's own power deficit, Bangladesh cannot solve its electricity demand to any significant degree through cross-border purchases. The important comparison with India is that the political economy of the power sector is somewhat different for a number of reasons that are relevant for understanding policy constraints in Bangladesh.

Unlike Bangladesh, the major leakage of rents in the Indian power sector takes place at the transmission and distribution (T&D) stage through the State Electricity Boards (SEBs) in each state. Unaccounted-for electricity (mainly due to theft or non-payment, but also some technical losses) amounts to an astounding 30 per cent of total supply, equivalent to almost USD 9.6 billion in 2010 according to GOI figures. These losses are projected to grow further to almost USD 14.5 billion in 2011. The likelihood of a possible future default in payments to power generators is therefore similar to Bangladesh and may have resulted in a similar vicious cycle of high risk premiums, high generation costs and shrinking time horizons resulting in a scramble for procurement rents if projects had to raise finance in private capital markets with high risk premiums added on.

Instead, while India's power sector clearly has a different set of problems it was able to add on significant amounts of generation capacity over the last three decades. The main factor that can at least partially explain this is the way in which power generation projects were financed in India. This financing has come partly from fiscal resources but also through a number of financial institutions, in particular the Power Finance Corporation (PFC), set up in 1986. The PFC is particularly interesting as it was set up as a special purpose development bank for power utilities. The government initially capitalized it with equity and tax free bonds. The timing of its creation was serendipitous. Within a few years the Indian capital markets had matured enough to develop an appetite for infrastructure bonds. In 1997 PFC underwent securitization and emerged with its balance sheet healthier. In 2007 the government of India divested close to ten per cent of its holdings in the company in one of the most successful initial public offerings by a PSE.

The PFC is the main provider of funds for investments in generation and does this through term and bridge loans, supplier's credit, debt refinancing and lease finance among other methods. It provides the public sector with up to 80 per cent loan coverage for generation projects and up to 50 per cent for private sector projects. The ability of the PFC to access public finances and borrow at credit ratings available for Indian sovereign debt significantly reduced the cost of capital in the Indian power generation sector. For instance, currently India's prime lending rate is 12.25% and most PFC loans are cheaper: between 10.75% for highly rated states and AAA rated companies to 12.25% for some non-rated private sector borrowers. The reduction in the cost of capital is significant. As a public sector financial institution, the PFC does

not need to add a risk premium when it is effectively relying on purchase contracts signed by the Indian state to recover its money.

The governance structure of the PFC cannot be replicated in Bangladesh because the PFC benefits from the checks and balances provided by India's federal structure. As a central government financial organization, the PFC is answerable to the central government, while most power generation projects that it finances come under state governments. This structure enables PFC to resist state politicians' attempts to influence the allocation of financing to their friends. This, together with strong professional bureaucratic leadership has ensured that PFC financing does not get captured by inefficient projects where the prime interest is procurement rents. In the context of a smaller country like Bangladesh, more attention would have to be given to the governance of a similar financial organization to ensure that credit allocation was not going to be captured by clients of the ruling party. On the other hand, Bangladesh has the advantage that the private sector is already a significant player in power generation. In Bangladesh, potential financing for power generation at manageable interest rates could be made available to winning private sector bids if the bidder satisfied technical qualifications. If bidders knew that partial financing would be available from a financial institution at an interest rate that did not have a high risk premium, this would create strong incentives for serious bidders to enter bidding and submit themselves to greater transparency. A focus on developing governance structures for financing power generation at preferential rates in Bangladesh is therefore likely to be a fruitful point of entry for cracking some of the political economy constraints facing investments in this vital sector.

Clearly, the availability of such a facility would have to be combined with dedicated governance arrangements to ensure that the financing available would only be available for projects that satisfied technical and other governance criteria. The IDCOL experience in Bangladesh suggests that this may be achievable. This may appear to be an optimistic expectation, but in fact procurement procedures were much better for Meghnaghat compared to some other cases. This is not surprising because if financing is available at a price that makes power projects credible, financial institutions have credible leverage for insisting on better procurement conditions. Secondly, with better procurement conditions and weaker incentives for fixing technical specifications, the adverse selection that results in serious bidders dropping out is less likely to happen. Thirdly, if upfront rents are less in evidence, the intensity of inner-party and bureaucratic lobbying can be expected to decrease, with the focus of interested parties shifting to a greater extent to the long-term rents from the production and distribution of power. This may not be less corrupt (as the Indian experience shows) but will enable a much greater flow of power projects to come on stream, which is what the country needs. None of these potentially beneficial results are likely to automatically follow without considerable attention being given to the governance design of any facility of this type in the future. But our analysis suggests that without a substantial facility which can promise to reduce the cost of financing and contribute to improving the viability of investments in the power generation sector, interventions that simply target some of the adverse characteristics of this sector are likely to fail.

6. Conclusions

My intention was to identify some major areas of policy challenges in Bangladesh and to suggest that there are pragmatic and do-able ways of beginning to think about policy responses to these problems. I do not wish to suggest that the kinds of ideas discussed here would be sufficient to solve the multi-dimensional problems facing different sectors and issues in Bangladesh. But I do believe that long lists of problems and multi-dimensional solutions are a bad way of thinking about what policy-makers can do. It is much more realistic given the limited reform capabilities in any country to think through to the most likely area where a change could make the greatest difference to the outcomes. A pragmatic approach to institutional and policy reform should begin with a small list of things to do which may be difficult but are potentially do-able if significant effort and political leadership was put into it. Remember the big impact that back-to-back LCs and bonded warehouses made to the garment industry.

There is another important policy message in the methodology adopted in this paper. The strategy of changing a significant part of the policy and institutional environment in a developing country at one go (as is implicit in the good governance and big bang liberalization attempts) is fundamentally misleading. But equally, the idea that governance does not matter and we can muddle through and somehow ‘manage’ is also seriously problematic as our economy becomes bigger and more complex and demanding. The intermediate position which is most realistic is that we cannot fix everything at the same time but we can and should try to identify and focus on a small number of institutions and agencies that we try to make effective. They will not necessarily work perfectly and fully transparently and without any corruption. But if we can put first class professionals in charge of a small number of critical ‘nation-building institutions’ and we are lucky to find public-spirited leaders for these agencies, and if political support from the highest political leadership is unequivocal and if we succeed in building the public support for these agencies, much can be achieved. The history of development success is based on the incremental building of such agencies and institutions.

7. Appendix

Table 1: Key Features of Bangladesh Economy 2000-

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GDP growth (annual %)	5.9	5.3	4.4	5.3	6.3	6.0	6.6	6.4	6.2	5.9	5.9
GDP per capita growth (%)	4.0	3.4	2.6	3.5	4.5	4.3	5.0	4.9	4.7		
Agriculture growth rate	7.4	3.1	0.0	3.1	4.1	2.2	4.9	4.6	3.2		
Agriculture share in GDP	25.5	24.1	22.7	21.8	21.0	20.1	19.6	19.2	19.0		
% Employed in agriculture	62.1			51.7		48.1					
Food Production Index	102.0	100.0	103.0	106.0	104.0	117.0	118.0	117.0			
Industry growth rate	6.2	7.4	6.5	7.3	7.6	8.3	9.7	8.4	6.8		
Manufacturing growth rate	4.8	6.7	5.5	6.7	7.1	8.2	10.8	9.7	7.2		
Industry share in GDP	25.3	25.9	26.4	26.3	26.6	27.2	27.9	28.4	28.5		
Manufacturing share in GDP	15.2	15.6	15.9	15.8	16.1	16.5	17.2	17.8	17.8		
% Employed in industry	10.3			13.7		14.5					
Services growth rate	5.5	5.5	5.4	5.4	5.7	6.4	6.4	6.9	6.5		
Services share in GDP	49.2	50.0	50.9	52.0	52.4	52.6	52.5	52.4	52.5		
% Employed in services	23.5			34.6		37.4					
Gross domestic savings (% of GDP)	17.8	17.0	18.4	17.6	18.7	18.1	18.4	17.5	15.8		
Gross fixed capital formation (% of GDP)	23.0	23.1	23.1	23.4	24.0	24.5	24.7	24.5	24.2	24.2	24.6

Sources: World Bank World Development Indicators 2010, Asian Development Bank. 2010 figures are estimates. Some cells are empty because data are not yet available.

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