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CURRENT LIBERALIZATION AND OTHER ECONOMIC REFORM ISSUES

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II. CURRENT LIBERALIZATION POLICY ISSUES

As in Working Paper 1, it would appear convenient to discuss the liberalization policy issues under some appropriate analytical classification headings such as follows:

a) Deregulation of investment controls;
b) Trade and exchange liberalization;
c) Financial sector reforms;
d) Privatization;
e) Other regulatory and promotional policies; and
f) Policy implementation issues including issues for ensuring dissemination and transparency of policies in place.

2.1 Deregulation of Investment Controls

The Government has now decided to remove altogether any requirement for formal approval of private investment projects other than for a special category of projects which need to be regulated on grounds such as environment, public safety, depletable resource management, etc. With this change, there would remain virtually no approval function control on private investment in general. This would be a far-reaching liberalizing reform. Private investments would henceforth be required to be only registered with government authorities: with BEPZA for EPZ-located projects; with BSCIC for small and cottage industry projects; and with BOI for all other projects. These changes have been incorporated in the 1991 Industrial Policy as revised up to December 1992, which has been published recently.

However, private investments would still remain subject to two types of limitation or control. First, the maintenance of the current Reserved List would preclude private investment in certain lines. Second, the Government will still retain the function of overseeing private investment projects on special regulation grounds.

A. Further Reducing the Reserved List

The current Reserved List of industries for exclusive public sector involvement which has still certain industries which could be opened to private sector investment has the effect of needlessly narrowing the scope of possible private sector investment. The Government has recently taken out power and telecommunications sectors from the Reserved List for the public sector. This List should include only those industries whose establishment would affect public security and health. There is scope for further significant reduction of the current Reserved List, as there is no sound economic or public safety rationale for keeping all of the remaining sectors in this List. This should be done in tune with the general world-wide trend of increasing privatization and reliance on private enterprise to improve business efficiency and consumer services. Out of the five industry groups[1] still remaining in the Reserved List, more sectors that should be considered for opening to private sector participation are air transport and railway, forestry in government reserved forest areas and perhaps export-oriented defence industries. This would be in line with the policy shift already brought about in many developing countries including India and Pakistan. In Bangladesh the Reserved List should be reduced to a barest minimum also in view of its special public resource scarcity problem and more urgent public investment needs in social sectors.

B. Streamlining Industrial Regulation Function

Private investments are required to seek government clearance from appropriate regulatory authorities on environmental, public safety and similar such grounds. It is not yet clear how this function would be performed and by what authorities. The issue here would be to ensure whether the Government adopts the same line as the best practice international standards of other developing countries to perform this industrial regulation function. The Government needs to define the scope of this regulatory function in order to avoid involving all but selected industries to be required to seek clearance on regulation grounds. The Government is committed to undertaking a study soon on this problem. Further, the requirement of formal approval from BOI of such projects in the regulated list should be withdrawn. This function should now rest with an appropriate governmental authority with competence in the specific regulation area.

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[1] These are (1) arms, ammunition, defence equipment and machinery; (2) production of nuclear energy; (3) security printing (printing of money & minting; (4) forestation of the reserved forest areas and their mechanical extraction; and (5) air transport and railway.

C. Simplifying the Investment Sanctioning Process

This process which remains for regulated industries leaves room for simplification, since the existing procedure is unnecessarily complex, time consuming and lacking in transparency. For instance, (until most recent decision to withdraw sanctioning requirement for regular projects became effective), while submitting application for investment, foreign investors were expected to provide documentary support relating to such matters as draft agreements between foreign and local partners, draft loan agreements where foreign loans are involved, bank certification of solvency, income tax payment certificates of local participants and evidence of bank commitments where local bank loans are involved, etc. No proposal requiring sanctioning was routinely approved. The Government used its discretionary authority to review each investment proposal on a case-by-case basis and to determine the terms and conditions under which an investment would be permitted.

Recurrence of such procedural complexities in investment sanctioning of regulated industries would be very undesirable and would especially discourage foreign investment. It is also necessary that loan sanctioning procedures of DFIs which are traditionally found to involve longer delays than sanctioning by government authorities are further simplified.

D. Making BOI and Other 'Sponsoring" Agencies Effective as Investment Promotion Agencies and Elimination of All Other Sponsoring Agency Functions

The Government should ensure that organisations such as BOI and where necessary, BEPZA for EPZ industries and BSCIC for small and cottage industries, are made effective investment promotion agencies rather than as bodies for bureaucratic control of investments. Only these institutions have now been authorised to serve as agencies to facilitate access to various incentives for investors such as access to site services and other incentives and facilities. These agencies should ensure that investors are not handicapped by delays in access to such facilities. To make BOI efficient in meeting its objectives, an effective tracking and monitoring system should be put in place to receive and deal with any complaints about delays and red-tape. The monitoring functions should include registration and analysis of causes of delays, actions taken to facilitate and speed up the process, as well as record of the effects of BOI actions.

E. Privatizing State Enterprises and Rationalizing Government Industrial Investment

The Government should create a more congenial environment for private participation in the newly opened and earlier opened industries by necessary privatization actions. This subject will be dealt with at some more length later. Two points that can be noted here in the present context are: First, keeping existing plants in government hands, e.g., those in power and telecommunications could by itself discourage new entrants in these fields since their operations (such as product pricing) would be affected by the public sector practices. Second, public sector units suffer from problems of politicized, over-employed and artificially highly-paid labor force, which affect present and potential private sector units in similar lines. Because of these reasons, it is desirable that the Government address the issue of privatization much more seriously and expeditiously than on current scale. A related issue in this context is that the Government should refrain from making further investments in any industry opened to private enterprise unless there is any convincing sign that the private sector is reluctant to invest in that industry for any reason. The Government should thus not only very carefully select industries for its future (continued or new) involvement in the form of direct investment, it should also more expeditiously undertake and implement a program of privatization of public enterprises (including divestment of government equity holdings in partially privatized industries) in sectors which remain opened to private sector investment.

F. Removing Restrictions on Machinery Imports

The ability of investors to freely import plant and machinery is an important determinant of the investment environment in a country. However, imports of currently second-hand/reconditioned machinery remain subject to certain conditionality restrictions. First, such machinery is required to be for industrial purposes only. Second, machinery imports above a specified value ceiling (Tk 200,000 per unit of machinery) require certification from an internationally reputable surveyor to the effect that the economic life of the machinery is at least 10 years. Such certification is required to be attested by the Chamber of Commerce and Industries of the exporting country. Such restrictions for private investors are unnecessary and these unduly affect private investment decisions. In a capital-scarce country and given Bangladesh's skill endowments, it makes little sense not to liberally allow imports of old/reconditioned equipment. Given the rapid technological advances, a few years' old equipment can be obtained at substantial discounts. The Government is pledge-bound to remove these restrictions under ISAC-2. This should be implemented without much delay.

G. Removing any Remaining Vestiges of Discrimination Against Foreign Investors

There is some confusion between the current reformed sanctioning requirements specified in the 1991 Industrial Policy as amended with recent changes and those specified in the Foreign Investment (Promotion and Protection) Act of 1980 which requires the satisfaction of specific conditions for the admission of foreign investment (see Chapter III). For instance, under the latter, sanctioning is still obligatory for any industrial undertaking which involves foreign capital and the Government has to be satisfied that the foreign enterprise will be involved in an activity which is not being carried out in Bangladesh "on a scale adequate to the economic and social needs of the country", etc. The existence of this inconsistency between the two policy statements is likely to contribute to needless confusion among foreign investors in Bangladesh and should be removed urgently.

Despite the removal of several impediments to foreign investment, de facto discrimination is still felt by foreign firms in a few areas.

It is not yet clear whether the current reforms in investment sanctioning requirements (which provide for abolition altogether of government oversight on private investment except for projects required to be regulated for special reasons), would automatically remove the de facto (if not de jure) ban on the entry of foreign firms in certain production lines such as certain pharmaceutical industries. If this discriminatory practice is still being continued, it must be removed.

The Government has recently announced simplified procedures for remittances of profits and dividends and capital gains, royalty payments, license and technical fees. Prior Bangladesh Bank approval would no longer be required for effecting such remittances, when such remittances (royalties and technical fees) are in accord with the BOI guidelines, as well as to purchase shares to set up industries or to investment in shares and securities through the Dhaka Stock Exchange and also to remit savings of expatriate personnel according to BOI-approved guidelines in the employment contract. However, the Government still requires that salaries and benefits of the Chief Executive Officers (and senior officials) of foreign firms should be approved by the controller of capital issues. This requirement is viewed by foreign firms as needlessly restrictive and an unnecessary intrusion on the part of the Government in the management of the firm. This requirement should be eliminated.

Despite repeated requests by foreign investors, expatriate personnel are still being restricted to two entry permits at a time. This entails frequent renewals of work permits, which is time consuming and an unnecessary hassle for the permit holders. The provision for multiple-entry visas for expatriate personnel should be urgently introduced.

Lastly, foreign investors are also concerned about the weak protection of patent rights in Bangladesh (which acts as a disincentive for the location of research-based companies in the country); and non-enforcement of labor laws. These issues would be discussed in more detail later.

H. Developing the Capital Market

A capital or stock market is an essential aid for companies which wish to raise capital by public issue of shares and debentures and is a tool for expanding industrial investment and for attracting both domestic and foreign private investment.

Some fiscal and other measures were taken recently to increase the investors' interest in investment in stocks such as a) lowering of the rates of interest on savings deposits in banks and on government-floated savings instruments; b) opening of the stock market to participation by non-residents and foreign investors in both primary issues and secondary market of shares and securities; c) tax exemption of capital gains on shares and securities; d) withdrawal of the 6% development surcharge and 4% Jamuna bridge levy from dividends; and e) allowing repatriation of both capital, dividends and capital gains with an eased procedure (without having to obtain Bangladesh Bank clearance). While these measures are steps in the right direction; more thoroughgoing and far-reaching reform and development of the very narrow and poorly developed stock market of the country is needed. Currently only 142 or so companies are listed with the Dhaka Stock Exchange, out of about 2000 public limited and 17,000 private limited companies registered with the Registrar of Joint Stock companies. Stock turnover of the listed companies as percentage of the total market value of their shares is dismally low (reportedly 2.5% as on September 30, 1992), compared to such high figures as over 80% in South Korea and over 60% in the Bombay stock market. This reflects current very low investor confidence in the Dhaka stock market. Both the narrowness of this market and the low stock turnover also suggest a general low level of investment activity in the economy and a gloomy investment climate.

A Capital Market Development Program Loan from the Asian Development Bank is currently under consideration of the Government, which has a detailed reform package for development of the Dhaka stock market. Some of the policy actions included in this package have been already implemented by the Government such as fiscal measures and liberalization of foreign exchange controls for foreign portfolio investment and of related foreign exchange remittances of capital, dividends and capital gains mentioned above. More measures which are likely to be envisaged under this program include: a) measures for promoting capital market efficiency by increasing reliance on market forces; b) measures for providing a wider range of capital market instruments; c) measures for improving capital market institutions and increasing private sector participation and d) those for promoting fair, orderly and transparent capital markets by increasing information and enhancing regulatory environment. Under the last category, Government's efforts are under way to establish soon a securities and companies commission as the main regulator for the securities industry. Improvement of the company law with enactment of appropriate amendments to Companies Act 1913 which provides for, among other things, improved protection for minority shareholders is also on the cards.

The issue here is speedy implementation of a desirable reform package to develop the existing stock market on a sound footing. (See more on this below under reform of business law).

2.2 Trade and Exchange Liberalization

In recent months, significant reforms have been introduced in this area under ISAC-2 and more reforms are under way. A revised Import Policy Order (IPO) has been brought out recently effecting some simplifying changes in import policy procedures and reductions in quantitative restrictions (QRs) on imports. The main issue here would be to closely watch and monitor whether the changes stipulated under ISAC-2 are being implemented on schedule or whether there are any significant lapses in implementation. Working Paper 1 provided a detailed outline of the changes which are expected to be brought about in this area. Some more issues that would seem to need attention in import liberalization and other areas are outlined as follows.

A. Removal of Restrictions on Imports of Second-hand Goods, Job Lots, Stock Lots, and Factory Rejects

The existing restrictions on imports of second-hand equipment were already noted (in connection with removal of restrictions on private investment). Second-hand goods, factory rejects and goods of job lots and stock lots of secondary/sub-standard quality are currently subject to import ban. Second-hand clothes are subject to quota restrictions. These restrictions should be lifted since the country can save substantial amounts of foreign exchange by importing such goods which are much cheaper than new goods and likely to be more appropriate for the price and quality requirement of consumers in Bangladesh. The choice should be left to the importer/consumer and the Government should not interfere. Import control on quality criterion can be hardly justified when domestic final product quality control is not enforced or is hardly enforceable. In fact, factory rejects are more often than not of reasonable good quality, as exemplified by rejects of export garments in Bangladesh, which are sold in the domestic market, but are highly sought after at the prices at which they are offered. Other reasons for existing restrictions such as opportunities for over/under - invoicing and problems of value and duty assessments do not stand on scrutiny. These problems can be overcome by development of suitable mechanisms and checks. Moreover, the engagement of pre-shipment inspection agencies by the Government should drastically reduce over/under-invoicing

B. Further Relaxation of Foreign Exchange Controls

Foreign exchange controls have been significantly relaxed recently. There still remain certain controls which should also be removed/relaxed. Despite a liberal path followed in recent years, the remaining exchange controls are perceived by both domestic and foreign firms as excessive. Such controls in Bangladesh also seem to have outlived their usefulness.

Recently the requirement for prior Bangladesh Bank approval for remittances on account of royalties and technical fees was abolished subject to the provision if such payments were in accord with the BOI-set guidelines. However, the currently set guidelines limit such expenses up to an overall 4% of the value of annual production capacity of the firm incurring such expenses. Cases with such fees exceeding 4% would need approval from the BOI's Executive Council (?) (Check). Expenses incurred for engineering services are not allowed at all to be included in approved business expenses. The present procedures are discretionary and stem from obsolete concerns about capital flight and transfer pricing. Furthermore, there is hardly any necessity for controlling such expenses where foreign exchange amounts involved are relatively negligible. Retention of the approval requirement would retain a rent seeking opportunity for officials and would certainly remain as an irritant for investors, especially foreign investors and would discourage the transfer of foreign technology when inflow of such technology is to be greatly encouraged to modernize and speed up the industrialization process. The 4% limit is definitely unduly restrictive by international standards. Too restrictive norms lead to regulation avoidance behaviour: mandated norm is stated in the agreement while actual payments are different. The present limit should be raised to a sufficiently liberal one to accommodate these legitimate business expenses without requiring any approval from BOI. In addition, the current ban on payments for engineering services, which is hardly justified, should be removed and these expenses allowed as permissible technology transfer related expenses.

More specific actions needed to further relax exchange controls would include: (a) satisfactory implementation of the recently announced measures of relaxation and streamlining of exchange controls; (b) automatic access to foreign exchange for domestic firms' foreign training and consultancy expenses under satisfactory guidelines; (c) allowing export firms to operate foreign exchange accounts so that they may hedge themselves against exchange risks when they convert their export earnings to taka and then reconvert them back to foreign exchange to import needed raw materials, machinery and spare parts; (d) allowing fully free movement of foreign exchange funds into and out of Bangladesh by both foreign investors and non-resident Bangladeshis working abroad without requirement for any approval from Bangladesh Bank or any other agency; and (e) a progressive graduated move to full convertibility of the taka. It is believed, in the case of (c), that conversion costs can be quite significant at times and place an export firm at a relative disadvantage viz-a-viz its competitors who are not exposed to such risks. In the case of (d), the perception of most stock investors and non-resident Bangladeshis is that the current regulations are too cumbersome and not conducive to free flow of funds into and out of the market, like, for example, the rules in Pakistan. Some liberalization was introduced recently in this regard. But more needs to be done.

In fact, Bangladesh should progressively move towards full convertibility of its currency as Pakistan and, more recently, India have done. One rationale frequently cited for existing foreign exchange controls and regulations is prevention of capital flight. World-wide experience suggests, however, that capital flight is directly related to exchange rate misalignment and political instability and that if the 'markets' perceive need for capital transfer, this would take place regardless of regulations which are ineffective. The presence of the 'hundi' market has made exchange controls virtually redundant and related subsidiary regulations unnecessary. Many of the existing direct and subsidiary foreign exchange regulations/controls are a legacy of the past, based on excessive concern for control of foreign exchange. Given the very comfortable balance of payments position, the time is now probably quite opportune for even full convertibility of the taka. This liberalization is unlikely to lead to any adverse impact. People are not about to incur foreign exchange expense just because it is liberally available. Loosening up will just impart <u>de jure</u> status to what is in any case happening <u>de facto</u> through informal markets. Also, capital flight is unlikely to be more than what is already taking place. If the usual experience of other countries adopting liberal foreign exchange regulations is any indication, such a policy would most likely improve rather than worsen the country's balance of payments situation. If immediate full convertibility of the taka is considered to be premature, a significant partial convertibility may be allowed in the initial stage by allowing exporters to retain 40% to 60% of their gross export earnings in their accounts and operate their accounts freely. India had resorted to some such partial convertibility before it moved recently to full convertibility of the rupee.

C. Ensuring Expeditious Customs Clearance

Delay in customs clearance of imported goods at ports which raises business costs and sometimes critically affects exporter firms' delivery schedules is an important issue to be resolved. Average time taken by the existing system to clear goods from port is known to be some 4 weeks, which is costly to industrial firms as larger stocks of goods for uninterrupted productions are required to be maintained. The Government (NBR) has recently taken some measures to ensure a speedier customs clearance process, which include publication of an operative tariff schedule and introduction of pre-shipment inspection service. More reforms including engagement of an international agency for offshore valuation and customs assessment are expected to be put into effect. Satisfactory implementation and operation of these reform measures need to be ensured so that the current delay in customs clearance is drastically reduced to 72 hours to one week.

D. Vigorously Pursuing Export Promotion

More actions needed to effectively implement the Government's newly announced export development strategy would include:

a) rapid expansion of the duty drawback system and its effective administration including rapid extension of the flat rate coverage;

b) vigorous extension of the special bonded warehouse system to export activities other than the few that now qualify for it and its satisfactory operation to include imports under non-back-to-back LC credit arrangements, to allow effective provisions for advance imports and to include pro-rating machinery and spare parts duty suspension for non-100 per cent export-oriented industries as well as to allow full exemption/suspension of recently reduced duties on the same items for 100 per cent export industries;

c) lifting of existing bans on re-export and export sales on consignment (on sale or return) basis;

d) continued flexible exchange rate management which involves time-to-time nominal exchange rate adjustment to keep the real effective exchange rate in line with changes in the currency market and domestic inflation rate relative to inflation in trading partners;

e) reintroduction of cash compensation system for smaller companies which are unable to enjoy special bonded warehouse or duty drawback facilities;

f) extension of export benefits to service industries such as shipping, construction, hoteling, etc. which are currently not provided many of the export incentives; and

g) satisfactory implementation of other aspects of the export development strategy including institutional development of EPB, NBR and commercial banks handling exports to enhance their capabilities to support the export-oriented drive.

For a successful export development drive, particular attention should be focused on three key areas: satisfactory expansion and implementation of the flat rate duty drawback system; satisfactory expansion and implementation of special bonded warehouse facilities; and flexible exchange rate management. In all these areas, the Government performance record is unsatisfactory. In addition, it is also important that the Government satisfactorily proceeds with implementation of agreed World Bank-supported import policy liberalization under ISAC-2. It is unlikely that the anti-export bias of the current policy environment will be significantly reduced without a significant measure of import liberalization and tariff reform.

2.3 Financial Sector Reform

Issues in the financial sector center on the problems of ensuring availability of both long-term and short-term credit to business firms at reasonable costs and on those of making financial institutions viable to service their credit deliveries on a long-term basis. These and other related issues are being addressed under an ongoing financial sector reform program. Pending the results of this program, we discuss here certain burning issues in this area.

The two DFIs, Bangladesh Shilpa Rin Sangstha (BSRS) and Bangladesh Shilpa Bank (BSB), which are the main institutions responsible for providing term loans to investors have failed to be fully effective institutions for a number of reasons which include procedural complexities, the ensuing delays and associated corruption. A recent study reported that delays in machinery procurement and corruption raised the interest rate to the range of 27-32% or a real rate of 15% or more.[2] There is thus a wide gap between the nominal interest rate which is much lower and the effective cost of funds. This gap, fuelled by the combination of delays and side-payments (which constitute 2-5% of value of loan), is the reason why for most firms financing from DFIs is the last resort. This high finance cost some times compounded by practice of over-invoicing of imported machinery cost often leads to over-capitalization of DFI-financed projects. DFI officials themselves are known often to encourage investors to inflate the cost of a project in order to extract higher unofficial payments.

[2] See Cookson, F., "Some Fundamental Factors Influencing Industrial Development in Bangladesh", mimeo, September 1991.

Many of the financing operations done by the DFIs have proved to be commercial failures resulting in a massive default of DFI loan recoveries. This coupled with the cessation of external funding from donor agencies led to a virtual collapse of the DFIs as any useful institutions. This failure of the DFI approach owes in part also to the fact that the DFI is a public sector agency which is vulnerable to undue influences from high government officials.

In this situation, DFIs need to be radically reformed to serve as effective development funding institutions. There seems to be no alternative to this since commercial banks do not normally engage in any financing other than for short-term purposes. The Government has moved to privatize BSRS, which is a positive step. Consideration should be given to privatizing BSB also. The Government should seek World Bank assistance to reform this institution as well as to replenish its funds to enable it to effectively perform its development financing function. It must be admitted that the drying up of financial resources with these institutions was one of the main reasons behind the low levels of industrial investment activity in the economy in recent years as well as in the eighties.

Limited access to both term and working capital finance is perceived by most entrepreneurs as the single most important constraint facing them. An appropriate approach to address this issue would be to reform the DFIs and the Nationalized Commercial Banks (NCBs) appropriately to effectively serve as financing institutions. The steps needed are (a) their appropriate recapitalization; (b) freeing these institutions from undue government influences through such actions as removing guarantees to loans and subsidies to interest on such loans provided to public enterprises; (c) taking appropriate measures to ensure loan recoveries and financial discipline, and (d) making these institutions operate as efficient commercial service centres by adopting market-oriented and market-dictated norms in their business operations. The Government has recently substantially replenished the funds of the NCBs, which should enable them to cater to business loan demands as well as to provision for past bad debts.

To restore discipline and fully free market-oriented operation in the financial sector, it is essential that the Government fully cease its practice of patronizing public sector enterprises with any assistance to enable them to get any privileged access to credit, compared to private sector firms. Both NCBs and public sector enterprises should be forced to operate strictly as market-oriented commercial entities. Existing government patronization practices rewarded the sick and losing concerns and punished the more efficient and successful firms and industries.

Another related issue with respect to the problem of availability of working capital, which shows itself not so much in the investment as the production side, is ridding the commercial banks of the undue influence of the central bank, Bangladesh Bank. As indicated in a recent survey, access to working capital finance from commercial banks appears to be significantly affected by the set of credit norm rules issued by Bangladesh Bank and applied for a large number of industry sub-sectors. These norms are a complex set of instructions governing the amount of working capital that should be made available. The norms issued by Bangladesh Bank are meant to be illustrative but are used as if they were regulations. The loan officer who is not ready to take any risk, as there is no reward for this, rigidly applies these norms. This results in more capital being available than needed with firms whose market may have shrunk necessitating production curtailment and less capital than needed being available to the firms growing faster than expected. The allocation of capital to the industrial sector for financing production costs rigidly according to the current credit norms thus operates in a perverse way rewarding the unsuccessful and punishing the successful. Resulting shortages of working capital have the effect of limiting capacity and production expansion. The industrialists would like to manage his receivables and payables with working capital from the bank while using retained earnings for increasing fixed capital. At present it is difficult to do this, with the result that short-term production-oriented capital is being partly financed out of retained earnings reducing what is available for fixed capital formation.[3]

Whether currently maintained interest rates are fully appropriate is another issue. It seems that even current practices which allow some freedom to commercial banks to choose rates are still not sufficiently flexible to allow for full play of free market forces. Interest rate variations that are being maintained between industry sub-sectors and for export sectors need reexamination, since such variations should depend solely on commercial banks' perceptions of returns and risks attached to different loans. The policy of maintaining subsidized interest

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[3] World Bank, "The Manufacturing Sector in Bangladesh: Selected Issues" (in 3 Volumes), "Bangladesh: Private Sector Perception of Impediments to Industry" (Vol. II), February 27, 1992, pp. 27-28.

rates for priority sectors also needs to be closely appraised since it is often not the nominal cost of credit which is at stake but the very availability of credit itself and the procedural complexities, associated delays and corruption involved in the process. It needs to be recognized that many businessmen and most small firms have hardly any access to the formal credit sector. They conduct their businesses through recourse to a large informal credit sector where the interest rates at which credit is availed are considerably higher than the nominal interest rates maintained in the formal banking sector. A major issue then turns out, how the formal banking sector can be reformed so that its services can be availed by all needing and seeking outside financing.

The readymade garment industry which normally gets its material supplies against back-to-back LCs is not much affected by the problems of access to bank credit. However, other export industries and especially new export firms suffer from special disadvantages in getting access to bank credit. To help resolve this problem, an Export Credit Guarantee Scheme (ECGS) and an Export Development Fund (EDF) have been in place, the latter commencing operation a few years ago. The operation of both of these systems is not quite satisfactory. The former scheme which is a credit insurance system puts the burden of insurance cost on the exporters themselves, which is discouraging them to fully avail themselves of the benefits of this scheme. The latter system which has a rollable capital of US $30 million to lend to exporters to finance their import requirements is terms of growth of utilization of the fund, reported to have had some notable success al beit from a zero base. Its more rapid use with fund enhancement would be clearly desirable.

To ensure full access to credit for export firms, there are two other types of bank lending operations which need to be closely studied: one is the system of establishing inland back-to-back LCs on the basis of master export LCs for getting supplies from domestic producers and the other is the system of issuing 'bid bonds' to enable local firms to participate in bids for supplies under international tender. Wide-scale use of the former system would help backward integration of the export firms, especially garment industry, with the local producers of fabrics and other raw materials, which is a critical need to boost export production and growth, especially in the textile sector. The latter system is required to encourage marketing of local products especially engineering products under international bidding system. Export firms do not have wide enough access to these facilities. Both these systems need strengthening to promote exporting activities as well as to ensure needed credit supplies for these activities.

Another issue is to ensure access to credit for small firms, which are especially disadvantaged, compared to large firms. The Government sought in the past to address this issue by requiring commercial banks to earmark part of their loanable funds for lending to small firms. Also, special funds were allocated to BSCIC for loan disbursements to small firms and a bank has been established in the private sector to specially finance small business activities. Fund allocation for special purpose loans is neither a sound policy nor does it work well. Instead, what the Government can do more efficiently is to reduce the special risks of lending to small firms by introducing a system of providing partial guarantees to commercial bank lending to such firms, up to a given percentage of such loans provided. Such schemes are known to be operating in India and Gambia with some successes.[4] USAID is considering making available a fund to provide partial loan guarantees to small firms. This would be a worthwhile project and deserves to be introduced as soon as possible.

2.4 Privatization

Although the 1991 Industrial Policy stated that an important aim of this Policy was to enhance the productivity of the government-owned industries by transferring them to the private sector and for this it underscored the need for intensifying the process of privatization that was in progress, the actual process of privatization action has proceeded at a snail's speed. As noted in Working Paper 1, the size of the industrial sector which is still in government hands is quite large. According to a World Bank estimate, the public sector's share of fixed industrial assets was some 40% in FY1985-86. This estimate may not have counted the proportionate public sector asset shares due to government equity holdings in the partially privatized textile and jute industries. According to one estimate, public sector share in fixed assets in textiles was as large as 70% after the major privatization of the early eighties was completed. Because of higher net accretion to capacity by the private sector in subsequent years, this share is likely to have perceptibly declined by now. Even then, the public sector continues to hold a very substantial chunk of the total fixed industrial capital formation, over 25 per cent according to the latest (1992) World Bank country economic memorandum. Some 225 public enterprises grouped under 38 corporations are still in operation.

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[4] See UNIDO, "Small and Medium Scale Industry in the GCC Region", Draft, 16 March, 1990.

Their share in GDP is low as agriculture, trade and services, which account for over two-thirds of GDP, are mostly in the private sector. Yet these public enterprises (PEs) dominate sectors that are large in scale, modern in technology, capital-intensive and have important forward and backward linkages. They also make a substantial contribution to the country's export trade. The largest number of PEs (145) are in manufacturing and cover industries such as textiles, steel and engineering, sugar, chemicals and jute. Currently electricity, gas and petroleum refining are entirely in the public sector, as also air transport and railway and telecommunications sector. The public sector also plays an important role in shipping and river transport. Four nationalized commercial banks and one DFI still dominate the financial sector activities. Another of the two DFIs is currently in the process of being privatized.

Although relevant privatization issues will need to be dealt with much more elaborately and comprehensively in another paper, here we could provide a brief outline of some major issues involved in this process.

It needs to be emphasized that if the Government is keen to accelerate industrial growth, it needs to accord a high priority to extension of private sector role and to privatization of government-owned enterprises, which is needed for extended private sector role as well as to remove certain constraints on private sector development that emanate from the poor performance of public sector enterprises and from often inappropriate pricing of the goods and services produced by them. The public sector enterprises have been incurring huge losses which have imposed a heavy burden on the economy and resulted in substantial budgetary resources being directed to them. The losses are, in part, due to inadequate pricing, at which demand for goods and services and for investment to produce them are artificially stimulated, thereby leading to substantial misallocation of national resources. On the other hand, the private sector is discouraged to invest in those sectors as their profit prospects are reduced. The government resources which finance PE losses could have been better utilized in development of physical infrastructure and social services which would have improved the prospects of private profitability and investment. Furthermore, many PEs suffer from problems of labor overemployment, wage hikes, a politicised labor force, and labor unrest. Operation of most PEs on efficient lines in such a situation is hardly conceivable.

Privatization would thus form an integral and important component of the liberalization process. The Government needs to implement a carefully designed comprehensive and expeditious program of privatization. In this program, the strategy, scope, forms and time tables of privatization need to be clearly spelled out, as also the measures that will be employed to overcome the problems that are currently being encountered in the privatization process. The Government needs to move swiftly since as more time is taken in bringing about this reform, the greater the obstacles that would seem to be built up to such reform. The reform policy that the Government needs and wishes to undertake should be stated clearly and soon, even if some aspects of implementation proceed at a more moderate pace.

For the sake of transparency and for sending clear signals to the parties involved, the Government should announce its long and short-range goals for privatization and private sector development. One of the failings of past efforts has been the lack of public education or awareness about the intentions and the benefits of private sector development. Also, insufficient attention has been given to allaying reasonable union and labor force fears about loss of jobs as a result of privatization of troubled state enterprises. The public must be made aware that the Government cannot continue to support bloated, unproductive payrolls indefinitely in the ailing public mills. If it tries to do so, the number of layoffs will be far greater than would be guaranteed by privatization after thoughtful restructuring.[5]

The Government identified in early 1992 42 enterprises for privatization, which comprised three types of privatization: (a) conversion of earlier 8 partially divested holding corporations into fully private entities by selling 51% shares held by the holding corporations; (b) outright sale of 28 enterprises by tender, and (c) partial divestment of 6 enterprises into holding corporations with divestment (sale) of 49% shares. For the last group, the holding corporation technique is being kept as these are monopolies or near-monopolies, or are profitable, and the Government wishes to retain some control. (These enterprises are in the production of cement, pulp and paper, insulators and sanitary wares, fertilizer and electrical equipment). In this program not only is the size and number of public enterprises selected for disinvestment/divestment modest, the principles used

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[5] Draper, Charles and et. al., "Bangladesh: Report on the Textile Industries Restructuring Study - Phase 1", Revised Draft, Washington, D.C., May 09, 1992, p.37.

in their selection are not clear. For a program to proceed smoothly, it is important that the Government clarify the principles of selection.

Forms of privatization which are being applied and which will be applied in the future should be carefully designed. Partial divestiture in order to retain control of the Government in the divested enterprises is often found to backfire as the very objectives of privatization are not fully realized. Monopolies can be controlled by appropriate regulation, and also by appropriate import liberalization measures.

Another constraining factor, aside from labor opposition, being faced in privatization efforts is the narrowness of the domestic capital market and the limited number of potential buyers. Part of the problem lies also in the fact that many of the public enterprises have a poor record of performance. These problems need to be carefully addressed by appropriate sequencing of sales and setting of realistic sales prices. While the Government should endeavour to secure the best possible prices, the Government's minimum prices should be set realistically for buyers to accept. Public enterprises that cannot be sold should, in any way, be liquidated and their assets sold.

2.5 Other Regulatory and Promotional Policies

Issues in these policy areas can be conveniently discussed under the following headings:

a) Improving the legal system for business;

b) Improving the system of fiscal incentives;

c) Strengthening institutions for investment promotion;

d) Development of special economic zones; and

e) Improving other miscellaneous regulatory and promotional policies.

A. Improving the Legal System for Business

A sound legal framework combined with its proper enforcement constitutes an important pre-requisite for the orderly conduct of business transactions. The FIAS study cited at the beginning of the paper has identified many serious loopholes with the current laws, legal procedures and institutions which need urgent and major reforms, both legal and institutional. According to this study, the legal framework for business transactions has been eroded in Bangladesh; many of the laws have become outdated, inadequate or inappropriate; and bureaucratic procedures and irregularities in the system have become pervasive. All this is affecting business confidence and investment.

The basic conditions which assure that business contracts can be enforced, that courts and government administration will function properly, that there will be security of title and that basic business communication of balance sheets and profit and loss statements which are duly audited and certified can be relied upon do not exist at present in Bangladesh. There has been a sharp deterioration in the legal system after independence with increasing political interference, corruption, inefficiency, outdated legislation, and lack of accountability of officials.

Key legal issues can be summarised as follows:

1. The basic autonomy of the judiciary is missing. The most basic principle of the separation of the judiciary from the executive and the assurance of the former's independence have not been ensured.

2. The litigation process in the courts has become unduly greatly time-consuming due to legal shortcomings, understaffed judicial system and other problems.

3. The basic commercial legislation is outdated. Among the laws in this category needing reform are (a) the 1913 Company Law; (b) the 1909 and 1920 Insolvency Laws; (c) the 1861 Admiralty Act; (d) the 1882 Land Transfer and Stamp Acts and the 1908 Registration Act; (e) the Banking Companies Ordinance, (f) the Foreign Private Investment (Promotion and Protection) Act of 1980; and (g) labor legislation.

4. The judicial administration process is faulty and law enforcement weak.

Some elaboration of some of these issues is in order.

The 1913 Company Law provisions lack transparency and its procedures are unduly complicated. Company law reporting requirements are weak and directors are not made accountable.

Minority shareholders are not provided the usual assurances of protection.

The 1909 and 1920 insolvency laws are not being used, and there is no liability for directors who permit a company to continue business while insolvent. Bankruptcies and liquidation proceedings are either not resorted to, because of falsely stated assets and liabilities or are too time-consuming in courts, a system which is actually supporting the continued operations of insolvent banks and companies. Current deficiencies in the system of establishing bankruptcies resulting in liquidation are a real hindrance in facilitating and enabling the closure and exit of enterprises as conveniently as possible, which is as important as clear and transparent regulations and practices that ease their entry and operation.

The 1911 Patents Law and the 1940 Trademark Law are outdated. They discourage innovation and, because they do not offer appropriate protection to developers, particularly discourage investment in technology-based industries and discourage foreign investment. The 1861 Admiralty Act is also outdated. It does not properly protect importers and exporters.

Both the sale and mortgage of land in Bangladesh are regulated by the Transfer Act, 1882, the Stamp Act, 1882 and the Registration Act, 1908. The problem with these laws is not necessarily that they are outdated, but that in their present form they are not practically implementable. In reality, dealing with real property has become an acute problem, with false title documents commonplace; parties avoid the registration of mortgages, liens and encumbrances of land because stamp duties and charges are excessively high. Another provision which creates considerable difficulty is that registered instruments, once they are registered, take effect from the date of execution (when the agreement is signed) and not from the date of registration. This means that until registration takes place, title is uncertain, so that a bonafide purchaser or mortgagee can still be defeated by a title or interest purportedly created earlier but registered subsequent to his. Another, more intractable, problem is the difficulty of ascertaining title to land and the existence of any encumbrances because of poor record keeping practices and storage facilities in many of the registration offices. It is also not clear, under the present law, whether foreign investors can purchase and own land in Bangladesh, or whether they can only lease them.

Recent studies and surveys on impediments to investment in Bangladesh list access to credit as a major constraint to investment. Traditionally, finance for purchase of machinery and equipment has been from the investor's own funds or from banks. The alternative method of finance, leasing of equipment, has not really developed in Bangladesh, unlike other parts of Asia. Unlike the situation, for example, in India, a bank in Bangladesh cannot engage in leasing activities because of a prohibition on banks' such activities remaining in the Banking Companies Ordinance.

Some of the deficiencies/shortcomings of the Foreign Private Investment (Promotion and Protection) Act of 1980 were already noted earlier. These relate to stipulation of certain conditions foreign investment proposals must satisfy to qualify for approval, which if so facto means denial of automatic approval for foreign investment and contradicts recent reforms. The Act also does not specify whether a foreign investor can have one hundred per cent ownership in an enterprise. Also one key omission in the Act is its omission of reference to a dispute resolution forum to which a foreign investor can have access in the event of an investment dispute. Furthermore, the scope of foreign investment defined in the Act is not broad enough to include all types of investment including forms such as investment through technology transfer and other forms of intangible transfers. The Act needs to be amended to remove these and other inconsistencies/deficiencies and possible confusion and feeling of uncertainty among foreign investors.

Labor unrest and non-enforcement of labor laws are a major deterrent to private investment (domestic and foreign) in Bangladesh. Labor legislation is at present contained in some 47 Acts, Ordinances, Rules and Regulations. Some of the more important ones are:

The Workmen's Compensation Act, 1923
The Payment of Wages Act, 1936
The Employers' Liability Act, 1938
The Maternity Benefit Act, 1939
The Minimum Wages Ordinance, 1961
The Employment of Labor (Standing Orders) Act, 1965
The Industrial Relations Ordinance, 1969.

There are a number of anomalies in the existing labor laws. These anomalies need to be removed by enactment of a comprehensive integrated labor code to establish the rights and duties of both employers and employees as well as to provide for speedy and effective access to justice for aggrieved persons. An ad hoc Commission for Examination of Labor Laws has been recently formed.

The task of framing a comprehensive labor code should be entrusted to either this Commission or to a Permanent Law Reform Commission which should review all laws.

Lastly, present judicial process, law enforcement and administrative procedures display serious abuses and short-comings. These need to be appropriately addressed.

The FIAS study has offered numerous specific recommendations to deal with the legal system problems and issues noted above. A summary of the key recommendations is reproduced in Annex 1.

B. Improving the System of Fiscal Incentives

The corporate tax and incentive system of Bangladesh, which affects business and local and foreign investors, has several features requiring reform and restructuring for promotion of investment on a sound footing. The system combines the features of a high tax, high incentives but unstable tax regime.

A stable and low-corporate tax rate regime would seem to offer much greater prospects for investment promotion than a high tax, high incentives but unstable tax regime. The corporate tax rate in Bangladesh, currently at 40% to 45% for industrial companies and 55% for other companies, is not only too high compared to those in other developing counties competing for foreign investment (in Pakistan, the rate is 35% at present), it is also not sufficiently attractive relative to tax rates of capital exporting countries. The famous four Far and South-East Asian industrial dragons (Hongkong, Taiwan, South Korea and Singapore) had their industrial success perhaps significantly attributable to low - level tax regimes.[6] Top marginal personal income tax rate has been significantly reduced in the current fiscal year (1992/93), from 45% to 30%, which is to be welcomed. However, the corporate tax rate should be substantially reduced, to around 25%, to give investment a major push and attract foreign investment. The negative revenue impact of such a measure is likely to be small and

[6] In Hong Kong, the standard rates of corporate and personal income tax rates were 18 percent and 16.5 per cent in 1987. Taiwan by a 1960 statute revised through 1986 cut the maximum rate of business tax on approved industries from 32.5 per cent to 18 per cent and provided for deduction of reinvested profits. South Korea and Singapore also kept taxes at low levels to encourage business expansion and attract foreign investment. See Rabushka, Alvin, "Tax Policy and Economic Growth in the Four Asian Tigers", Journal of Economic Growth, Vol.3, No. 1, 1987.

could be compensated by revenue gains from increased inducement to investment, streamlining of exemptions and holidays and greater tax compliance.

There is also hardly any strong economic rationale for maintaining different tax rates for different types of companies. The rate charged is 40% in the case of publicly traded industrial companies, 45% in the case of other industrial companies and 55% for all other companies which are in trade, financial services, etc. Tax rate differentiation between industrial and non-industrial activities is hardly desirable especially when the latter activities are not provided any tax break facilities and when harmonious development of non-industrial activities is as important to the development process as that of industrial activities. Also, the differentiation some times creates problems for tax administration in drawing lines of demarcation between the two types of activities. Such tax differentiation also encourages tax payers to resort to tax avoidance behaviour. The tax differentiation between publicly traded and other companies to encourage companies to become public also seems relatively inefficient or redundant when there are perhaps better and stronger ways to provide such an incentive (e.g., through tax exemption of dividends of such companies as a supplement to the incentives being provided to firms to offer equity). There is thus a case for unifying the different corporate tax rates into one rate, which will simplify tax administration and make it more efficient.

The system of lavish tax holidays being used as an incentive to promote industrial investment, both domestic and foreign, and encourage greater regional dispersal of such investment does not seem to have worked. Domestic firms are found to pay little tax in any case. So what incentive they receive through tax holidays is unclear. Also, whether such an incentive is worth the cost it entails in terms of forgone government revenue and benefits of possible increased government expenditure with such revenues is not apparent. There is also no hard evidence available to suggest that the system of higher tax holidays offered for more backward areas has promoted regional dispersal of industries in a sound manner to any significant extent. Development of infrastructural facilities is a better policy instrument to promote such an objective than a tax incentive. Moreover, tax holidays are being abused extensively to evade taxes after the tax holiday expires.[7] Tax holidays are

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[7] For more details on the various aspects and implications of the tax incentives being used, see Delatour, Leslie and Rab, Abdur, "Bangladesh: Tax Incentives Report", Study 3 of FIAS report on the

also not proven effective instruments for encouraging foreign investment. The general policy environment, an open and less restrictive regulatory policy regime, a stable macro-economic framework, a good labor situation, good infrastructural facilities, and above all political stability and good security situation are some of the other things which count as more important factors to foreign investors than generous tax incentives.

However, to the extent a tax system counts, using a low tax rate system even without tax holidays would appear to be a much better alternative to the current high-tax high-incentive regime. If tax holidays can not be abolished at once in tandem with proposed lowering of the tax rate, the holiday period should be substantially reduced and holidays targeted to a narrow range of priority sectors (e.g., EPZs, export industries).

There are other desirable fiscal incentive reforms that should also be carried out. Tax on dividend income should be abolished for providing necessary incentives to equity investment and capital market development. The tax is inappropriate for a country like Bangladesh that needs to vigorously promote such investments. Tax on capital gains on stocks and shares was removed altogether recently, which is a welcome piece of reform. The Government has also recently announced a 50% income tax concession for all 100% export industries. This should be made available to all exporting firms on a pro-rata basis.

C. Strengthening Institutions for Investment Promotion

Strengthening the Board of Investment (BOI) as an effective investment promotion agency is an important current issue to be addressed. The BOI, which has its counterparts in several Asian countries, was originally established as a one-stop agency to serve both investment regulatory and promotional functions which included providing assistance to firms for access to various government facilities and incentives and site services such as electricity, gas, water, telecommunication services, etc. The BOI has, however, failed to serve as an effective one-stop agency and its investment promotional role is in question.

Its ineffectiveness can be blamed on several factors: a) retention of investment sanctioning and other regulatory functions which made it to function more as a regulatory body; (b) entrusting it with unrealistic powers of assuring firms of prompt access to

regulatory, legal and incentives framework, October, 1992.

various site services that are within the jurisdictional areas of other institutions which resented and flouted BOI's directives; and (c) the organizational weakness and corruption within itself. A recent survey suggests that the success of the BOI to fulfil its mandated objectives, as perceived by entrepreneurs, is at best modest. The institution is plagued with the problem of bureaucratic red-tapism within its own organisational set-up. Little effective assistance is offered to newly established firms to overcome their pre-operation constraints. For example, a letter from BOI to the Power Development Board (PDB) or the Rural Electrification Board (REB) for assistance to power connection is given little heed. The road to timely power connection is not a BOI letter, but side payments to the PDB or REB personnel. Without bribes or personal connection, it is well nigh impossible to expect prompt access to site services. There are also complaints of inefficiency and corruption against the BOI itself.[8]

Yet the establishment of the BOI marks an important milestone in the evolution of the institutional structure for promoting private investment, both domestic and foreign. The need for such an institution was felt as a key role that can be played by such an institution, as part of a strategy of relying on private sector development, is creating and ensuring the efficient operation of a clearly defined and transparent policy and regulatory framework that will encourage and facilitate (not direct or control) private investment. There is room within this paradigm for an agency that would (a) assume an advocacy role in reducing and making transparent the regulations and procedures that affect both the formation of new and the operation of existing enterprises, and (b) provide a service to investors by assisting them in dealing with other Government agencies and departments. However, this agency should not put itself in the position of the sole supplier of such services, for the real test of the effectiveness of such an agency is when investors choose to access its services because they are valuable to them.[9]

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[8] See Data International, "The Impact of Industrial Policies in Bangladesh: A Question Revisited", April, 1991, pp. 1 and 20. Also for similar conclusions see Kabir, Kaiser, "The Regulatory Framework for Industry and Private Sector's Response to Liberalization Policies in Bangladesh", April, 1991, p.21.

[9] World Bank, "Bangladesh: Review of Current Industrial Policy Measures", Draft, April 03, 1990, Section 3, P. 21.

The BOI establishment resulted in an immediate elimination of a number of Government institutions previously involved in the regulatory system. It has certainly led to a measure of easing of the current regulatory process facing industrial entrepreneurs and facilitated their access to certain government incentives and facilities such as duty concession on imported machinery and fiscal tax holiday incentive and perhaps helped firms get speedier access to site services. The various authorities responsible for supplying site services, e.g., PDB, WASA, T&T, etc., are representated in the Board.

On the other hand, it has become another arm of government bureaucratic regulation and abuse. It has not yet been able to transform itself from a regulatory bureaucracy into a full-fledged facilitating agency. Formed out of the old Department of Industries absorbing most of its staff, it has not yet been able to bring about a radical change in attitude in harmony with its avowed objectives.

Recently there have been both organizational and functional changes effected for the BOI to make it more effective as an investment promotion agency, following a FIAS study report. The Government has shifted the agency from the Ministry of Industries to the Prime Minister's Office, upgraded its Executive Chairman, and initiated the design of further organizational changes to reflect its new mandate. The Government has also removed some of its regulatory functions such as investment sanctioning for industries except probably for regulated industries, approval function of capacity increases of foreign firms, approval function of the terms of suppliers' credits falling within Government prescribed norms, etc. The BOI has also made transparent guidelines with respect to several kinds of foreign exchange remittances especially involving foreign investors; within such guidelines, the investors are exempted from seeking approval of any agency including Bangladesh Bank.

These are certainly welcome improvements. Further changes expected to be implemented under ISAC-2 are appointment of qualified Board members and substantial restaffing of the BOI secretariat. The Government has requested further FIAS assistance to implement further reforms in a three-year program funded by the UNDP under a project document signed in May, 1992. It would remain important to watch and monitor whether this institutional device effectively and satisfactorily performs its mandated objectives of promoting and facilitating foreign and domestic investment in all sectors of the economy in the coming years.

D. Development of Special Economic Zones

The development and use of special economic zones, also called 'export processing zones', as a tool for especially attracting foreign investment and thereby accelerating industrial development has found wide acceptance among many developing countries, including even socialist countries. In some of these countries, such a technique has proved to be immensely successful. In socialist China, for example, there are many economic zones where foreign investment has been actively and successfully encouraged. In one of these zones, Shenzhen, more than 10,000 foreign-funded enterprises have been established involving a total foreign investment of nearly 10 billion US dollar by the end of 1992.[10] In contrast, only some 45 foreign-funded projects have been established in the Chittagong Export Processing Zone (EPZ) by October, 1992 involving a total investment of some US$ 85 million. Currently, the Chittagong EPZ is the only EPZ in developed operating status in Bangladesh. Some of Bangladesh's neighbouring countries have multiple EPZs. Sri Lanka, for example, has three such sites which have succeeded in attracting substantial foreign investment. Foreign investment in this country rose from US$ 55 million in 1981 to US $ 385 million in 1991.[11] EPZs are a special attraction for foreign investors for a number of reasons. In addition to the especially important condition that investors can operate with full free trade status to their transactions, other important facilities offered by such special economic zones include developed land, sometimes with ready-built standardized factory buildings, and all utility and off-shore banking facilities and other various facilities and special incentives. EPZs are also protected areas with fully assured impeccable security situation and are insulated from labor unrest problems. Investors are least bothered with regulatory or procedural complexities and delays usually faced by entrepreneurs outside such zones. They enjoy special customs clearance benefits.

For attracting foreign investment, EPZs thus offer an ideal solution. Bangladesh has currently plans for expanding the Chittagong EPZ and developing another EPZ in Khulna area. One EPZ

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[10] Source: Quoted and reported by Chinese news agency Xinhua, news item published in the Daily Star in its issue of 17 January, 1993.

[11] Source: Prime Minister's address in a conference of the World Export Processing Zones Association quoted and reported by Sri Lankan news agency UNB, news item published in the Daily Star in its issue of November 17, 1992.

in the outskirts of Dhaka in Savar area is well in the process of being completed. Bangladesh should have taken up these projects with greater urgency. It would be important to take up and complete the other EPZ projects on a priority basis.

E. Improving Other Miscellaneous Regulatory and Promotional Policies

With the recent removal of BOI approval function of industries, it is not yet clear whether BOI still retains its approval function of industries which qualify to be regulated on special grounds. Previously BOI used to exercise the power of approving industries in the "Discouraged List'. This list was abolished but its place was occupied by a new type of 'regulated industries'. This introduction is old wine in a new bottle and hence it deserves to be scrapped for the same reason for which the Discouraged List was abolished Projects which require review on grounds of environmental, ecological, public health or safety considerations should continue to be subject to such reviews by the appropriate governmental authority having requisite competence in the relevant area, but should not be subject to BOI review and approval. If investors so choose, BOI could only serve as a facilitating agency in getting expeditions reviews of such projects from the required governmental agency.

The Government's concessionary duty policy for imported machinery was designed to promote investment in less developed areas. This policy has not served its avowed purpose as few investments have been established in less developed areas. In some cases, it has led to perverse effects: e.g., establishment of some industries in city outskirts and other places with inadequate infrastructural facilities and communication links adding to project costs and leading to their commercial failure and in certain other cases leading to shifting of machinery from less developed to more developed regions. The policy of maintaining a differential system of duties for machinery is basically unsound and hence should be withdrawn. Pending this reform, the customs department alone should be entrusted with the tasks of enforcement of duty concessions, as it does in other cases such as for duty drawback and issuing of special bonded warehouse licenses. It is, therefore, unnecessary that another organization like BOI should continue to have any role in this. Involvement of any agency is likely to increase their rent seeking opportunities. Hence the BOI involvement in the matter of administration of duty concession for machinery should be done away with.

The Government has recently allowed imports financed by direct payment abroad by non-resident Bangladeshis and an Import Permit or Clearance Permit from the CCIE is no longer required for such imports. Cessation of the requirement for an Import Permit should be extended to all importers for all freely importable items. Other import procedure simplication measures envisaged under ISAC-2 but not yet brought in place should be implemented with due urgency. Such permits should be required only in the case of goods which still remain on the Control List after necessary desirable reduction of the number of items on this List.

There is currently a value added restriction in place with respect to imports of raw materials in the readymade garment industry. The Government increased the local value addition content from 25% to 30%, and export-oriented garment units are allowed import of raw materials up to 70% of the FOB value of exported garments. The new policy has led to discouragement of production and export of high-value garments with high-value fabrics and styles. What matters most is net dollar earnings per physical unit of exports. Thus a 10% value added on a US$ 50 silk shirt provides much greater foreign exchange than 30% value added on a US $10 T Shirt. Therefore, the current value added policy restriction should be withdrawn or amended to allow automatic exceptions for higher-value products.

The pharmaceutical industry in Bangladesh is subject to certain special types of regulations under a drug policy. This policy is being reviewed by the Government. The regulations need to be streamlined along the following lines:

a) The current drug policy has arbitrarily fixed the number of pharmaceutical products that can be manufactured at 302 despite a ruling against it issued by the High Court. The current limitation of products is hurting the entire industry and encouraging smuggling. Production of new products, especially those which are finding their way into Bangladesh from abroad, should be allowed by issuing free sales certification.

b) Pharmaceutical products are subjected to price controls. These controls need to be lifted. Freedom of pricing must be allowed to both manufacturers and importers. Without this, neither quality of products can be ensured nor products in high demand can be increased. Liberalization of imports would ensure that domestic prices remain competitive and do not unduly increase once price controls are lifted.

c) There is currently a ceiling imposed on marketing expenses, which is 5% of sale. Also, under the current policy, manufacturers are not allowed to use sampling as a way of promoting their products. The manufacturers feel that the control over advertising should be removed from the drug licensing authority and if such control needs to be retained it should be administered by a separate self-regulating body within the industry.

d) Currently pharmaceutical companies can import within an approved block list of pharmaceutical new materials and are not allowed to import their inputs freely. Such controls do not seem to serve any useful purpose. These do not in any way ensure product quality nor do they protect local manufacturers because of illegal imports. There are other ways of ensuring product qualities such as random sample tests carried out by the Drug Administration and publicizing these results through mass media so that consumers can take precautionary measures. Hence the current import controls on pharmaceutical raw materials should be withdrawn.

f) Finally, there are at present certain de facto (if not de jure) restrictions on the specific pharmaceutical product lines that can be chosen by foreign firms. Such discriminatory practices must be eliminated by an explicit policy statement.

For encouraging foreign investment on a vigorous scale, the Government should engage in an active promotional campaign. Some systematic efforts that should be undertaken include holding of foreign investment forums inviting foreign entrepreneurs, publication of appropriate advertisements in international magazines publicizing the investment advantages offered in Bangladesh and especially in the EPZs, consolidation and codification of all relevant laws and regulations into a comprehensive guide for foreign investors and publication of a handbook containing relevant commercial and investment laws, regulations and procedures to promote investment and activation of Bangladesh's foreign mission for undertaking a greater promotional role in this regard. Currently many investors are discouraged simply because they do not know what the rules are. The number of countries with which Bangladesh has entered into bilateral investment protection agreements and avoidance of double taxation agreements should be reviewed and more countries which promise to be prospective investors should be brought under these agreements.

2.6 Policy Implementation Issues

The PIAG's main concern will be to increase the effectiveness of existing policies, on making policies and regulations that are on the books work, rather than on formulating new policies. Indeed, as Working Paper 1 shows, Bangladesh has by now made commendable progress in liberalizing and reforming policies in many areas. The 1991 Industrial Policy, with its professed broad policy directions and recent reform modifications, makes an impressive and apparently attractive policy package for prospective private investors. However, there remains a wide gap between this stated policy and what is being perceived by entrepreneurs as being actually implemented. As a recent World Bank report has aptly put it,

> "In the view of many entrepreneurs, and foreign investors in particular, the failure to implement current regulations is a far more serious problem than the limitations of the laws themselves. The private sector entrepreneurs generally agreed that Government's liberalization policies are appropriate but are concerned about their implementation. The lack of implementation is attributed to the heritage of a centrally planned economy, compounded by poor administrative capabilities and widespread corruption. This explains why traces of rules, such as the restriction on foreign investment to a minority participation with public enterprises, can still be found in the Government's joint ventures. The problems faced by BOI provide further evidence of the lack of implementation capacity on the part of the Government. BOI's role as a one-stop agency is often opposed by other government agencies who resent the elimination of their previous authority."[12]

Policy implementation problems consist of or stem from various factors such as non-enforcement or weak enforcement of existing laws and regulations, inappropriate application of existing regulations, procedural complexities, non-transparency or vagueness of existing rules and regulations, lack of appropriate organisational or institutional developments, traditional bureaucratic inefficiency, inertia, delays and corruption, etc., on the one hand as well as lack of appropriate subsidiary rules and regulations themselves required for implementation of policies on

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[12] World Bank, "Bangladesh: Selected Issues in External Competitiveness and Economic Efficiency", Report No. 10265-BD, March 16, 1992, P.82.

the other. Rapid implementation requires rapid translation of the existing policy provisions into regulations and instructions to guide implementing offices and agencies and application of regulations and procedures so that firms' transactions with the regulatory authorities are as few, simple and expedient as possible.

Significant policy implementation issues will need to be identified, analyzed and addressed with the help of appropriate surveys, collection of baseline and periodic relevant information on implementation of important policies, establishment of mechanisms for monitoring implementation of important policies and establishment of methods and institutions to enhance the effectiveness of existing policies including their transparency and dissemination and promotion of informed dialogue and feedback between government ministries affecting industrial expansion.

Significant policy implementation problems and issues will need to be addressed comprehensively throughout the span of the PIAG project. It will be a continuing exercise and process as new problems can arise and greater insights into the problems can be gained as the implementing agencies proceed with implementing existing policies and as monitoring of the implementation process is conducted and analyzed. Policy implementation issues that will need close attention of the PIAG fall in the following three broad groups:

a) Identification of important policy areas where significant implementation problems are noticed;

b) Analyzing the nature of the implementation problems identified and their causes; and

c) Suggesting appropriate remedial measures to deal with the implementation problems.

Several important liberalization policy areas where implementation problems are apparently significant include:

a) Government official or DFI approval of investment projects including foreign investment proposals;

b) Sanctioning and disbursement of DFI loans to investment projects and DFI approval of machinery imports;

c) Firms' access to project and working capital credit from commercial banks;

d) Import policy liberalization and tariff reform;

e) Administration of duty drawback and bonded warehouse systems;

f) Privatization of state-owned enterprises including divestment of government held equities in holding companies;

g) Reform of retained public enterprises;

h) Development of export processing zones;

i) Privatization/reform of nationalized financial institutions;

j) Privatization/reform of state-owned public utility service organizations;

k) Reform/enforcement of business laws; and

l) Administration of miscellaneous regulatory provisions for business.

III. COMPLEMENTARY FACTORS AFFECTING PRIVATE SECTOR BUSINESS

This section is not intended to be a long one. It is meant to put on record an important reminder that business investment, especially one that is intended to be led by the private sector, is determined by a multitude of factors, not just good liberalized policies. It is very important that the Government does not remain oblivious of the necessity of ensuring all factors that contribute to development in a mutually supportive and synergistic manner. We mention below some critical complementary factors affecting private sector development in Bangladesh. These relate to but not limited to the following areas:

a) Public security situation;
b) Labor situation;
c) Wage policy;
d) Public infrastructure development;
e) Public human resource development;
f) Macro-economic policy situation; and
g) Public enterprise performance situation.

We briefly touch on these factors below.

3.1 Public Security Situation

The previous section has covered the situation relating to the legal system affecting business. Here we touch on the general public security situation.

In the view of many businessmen, the general law and order situation in Bangladesh is very lax and public security is seriously lacking. This is an important factor having negative influence on business confidence and investment. Unless security to life and property can be fully ensured, private business confidence can hardly be restored and this will seriously continue to affect both domestic and foreign private investment. Various factors including an inefficient and corrupt police administration contribute to the present situation.

The present Government, being alive to the situation, has recently passed and put into effect an anti-terrorism act. However, satisfactory improvement of the current situation still remains to be made. The Government needs to put in more determined efforts to deal with the current situation.

3.2 Labor Situation

Labor unrest is also cited by private entrepreneurs as an important factor affecting their zeal for investment. The recently constituted Task Force for Industrial Development mentioned the labor situation as a key problem demanding urgent resolution.

Various reasons account for current labor problems. Organized labor unions wield considerable power in Bangladesh. Political parties maintain close links with labor groups and their leaders. Labor has thus become highly politicized. Existing institutions, such as the Labor Department and the courts, have not been very effective in resolving labor disputes; the labor code is, therefore, often not applied. There are problems with the labor legislation as well, which were discussed in the previous section.

Formal labor unions cover only a small part of the labor force, but they exercise considerable influence because of their concentration in large industries in urban centres and because of their links with political parties. They are, therefore, able to exert considerable political pressure through visible strikes, demonstrations and other forms of labour unrest. Resolution of labor management disputes at the firm level is often hampered by undue political interference. Labor unions and their federations to which they are affiliated often come up with unrealistic demands that are inconsistent with the needs of modernizing the economy and creating more jobs. Industry-based federations have been ardently opposed to Government privatization efforts.

The Government's handling of the labor situation has been weak and inept. Its agreement in 1984 with the Sramic Karmachari Oikkya Parishad (SKOP), which is the main representative for all trade union federations, led to a sudden undue increase in wages and certain other policy changes. The role and legal status of the SKOP are, however, seriously contested by the employers. This agreement by-passed private sector employers and was inconsistent with the principle of tripartite consultations. More recently, the new Government has been engaged in dialogue with labor federations in the jute and textile sectors and with SKOP, particularly in response to labor demands and agitation, including calls for country-wide strikes. These negotiations have culminated in the signing of agreements between the Government and the labor federations. Some of the major provisions of the agreements are: the formation of a National Wage and Productivity Commission to review the compensation package for workers of the public enterprises; retroactive effectiveness of enhanced wage awards; provision of interim wage increases; establishment of statutory national minimum wage to be applicable to the private sector; review of labor laws; and assurance provided by the Government for further discussions on the proposed denationalization program and other unresolved issues. The National Wage and Productivity Commission has now submitted its report to the Government and its recommendations are under its consideration. In this report, the starting wage for the public sector workers has been proposed at Tk. 1,610 and the national minimum wage has been recommended at Tk 900 per month. These recommendations have already been criticised by the Metropolitan Chamber of Commerce and Industry and the Bangladesh Employers Association. According to them, these recommendations, if accepted by the Government, will lead to undue increases in wages (See the next sub-section for more details).

The politicization of labor disputes has led to very difficult labor management relations and hampered the application of the labor code. In particular, it is very difficult for firms to lay off excess workers.

The Government needs to appropriately and adequately address these labor issues to ensure a congenial environment for industrial investment, for promoting foreign investment, and to maximize private-sector-led industrial growth and employment. A well-designed strategy for reform of the labor situation needs to be formulated. The Government will have to rethink its current intervention policy on labor disputes, review and formulate changes in broad policy guidelines on labor practices, rectify anomalies in the current labor laws and ensure their enforcement. The Government should refrain from involving itself in the specifics of the terms of employment but should leave this to negotiations between the trade union and the employers concerned. Simultaneously existing institutions such as labor administration and labor courts should be strengthened and procedures streamlined for settling labor disputes.[13]

3.3 Wage Policy

Some reference to the need for appropriate wage policy has been made above in the context of labor policy. Keeping real wages in check and in harmony with the employment-unemployment situation as well as productivity of economic activities is of critical

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[13] For more details on labour issues and a suggested strategy to deal with them, see World Bank's 1992 CEM, Report No. 10265-BD, loc. cit., pp.63-67.

importance to ensuring competitiveness of such activities and acceleration of development and employment growth. In Bangladesh public nominal wage policy in recent years has been grossly out of line not only with productivity changes but also with the rapid expansion in the labor force and an apparent decline in formal sector employment.

Available labor force survey (latest 1989) and population census (latest 1991) data indicate a faster increase in the country's employable labor force over the past decade than population increase itself. This implies a grim worsening unemployment situation on top of an existing vast pool of unemployed and underemployed workers. This situation has been compounded by the facts that the formal sector employs a small portion of the labor force, only 9.5%, and that employment in this sector declined during the second half of the eighties.

On the other hand, real wages in the formal sector (especially the public sector) have been increasing. Real wages of selected blue collar grades of workers in public enterprises increased by 27-36% during FY83-91.[14]

Public sector wage policies directly or indirectly affect wages in the private sector and have an important impact on competitiveness and prospects for employment generation. As the largest employer in Bangladesh, the public sector acts as a leader in setting wages. Public wages have strong effects on private sector wages particularly in sectors where both public and private firms operate, such as jute and textiles. Compensation increases for government employees also encourage labor unions operating in other sectors to demand comparable treatment. Undue increases in public wages unlinked to productivity increases coupled with excessive employment have been important factors underlying the poor financial performance of many public enterprises.

In the back drop of these developments, the recommendations of the recently completed National Wages and Productivity Commission, which is under consideration of the Government, need to be considered with utmost care. The recommended minimum wages of Tk 1,610 and Tk 900 per month respectively for public and private sector workers and other wage proposals would, if implemented, mean another dose of a significant wage hike and would seem to be inconsistent with the other relevant economic parameters or

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[14] Estimates as shown in the recent World Bank report, _loc. cit._, pp. 60-61.

variables. The fixation of recommended minimum wages especially for the private sector is not in order also from the point of view of the existing unemployment situation and in view of the appropriateness of wage determination on a bilateral employer-employee basis. The wage employment trade-off is a critical issue which the Government needs to address with utmost care and attention if it is to promote competitiveness for export expansion and accelerate industrial development.

3.4 Public Infrastructure Development

The development and maintenance of good infrastructural facilities in tune with the needs and developments in other sectors of the economy is another important sine qua non for promoting rapid development. The key sectors needing focus of attention are power and transportation and communication. One of the main criteria used by foreign investors to judge whether a favorable investment climate is present in a country is its state of infrastructural development. Overall, the current impression of foreign investors about Bangladesh in this regard does not seem to be very good.

Public investment in the energy sector considerably fell in real terms in recent years since FY 1987 resulting in inadequate energy (gas and electricity) supplies and capacities to support future viable developments in other sectors including fertilizer production and the proposed high-investment Jamuna bridge project.

Currently the problem is especially acute in the case of electricity supply. Shortages and frequent outages of power are seriously disrupting and hampering existing industry operations and future connections. Uninterrupted availability of electricity is critical to future industrial development. The World Bank has delayed approval of a proposed support to the Power Development Board's investment program in view of its and Dhaka Electric Supply Corporation's unsatisfactory management record resulting in a high system loss and poor financial performance. It is very important that the Government puts in serious efforts to satisfactorily improve the performance of these organizations to encourage timely of donor support to this vitally important sector.

The Government should accord high priority to addressing inadequacies in other infrastructure facilities such as roads and highways and modern telecommunication facilities which are in special demand by existing and prospective industrial investors including foreign investors and in particularly designated areas and urban centres where industries are and would be located.

The Government should at the same time actively encourage private foreign investors to invest in infrastructure development projects including development of gas, electricity and telecommunication sectors, now that these sectors have been opened to private investment.

3.5 Public Human Resource Development

During much of the eighties, the Government investment program neglected the social sectors. In the education sector, for example, public expenditure stagnated in real terms until FY87. In FY88, expenditure for education comprised only 1.8% of GDP (10% of government expenditures), a level which was one-half or less of the level found in many low-income countries. Since FY87, public investment in this sector has been substantially increased. There has been a renewed emphasis on development in the education sector in more recent years: sectoral allocation in public investment program for education was increased to 11.7% in FY92 from 7.2% in FY91. Substantial increases were made also in investment for health.[15] These shifts in public expenditure priorities are in accord with the high priority clearly warranted by human resource development needs. In Bangladesh, current levels of human capital formation are unacceptly low by any standard and constitute a serious constraint on the country's long-term development prospects. The total adult literacy rate is estimated at 35%, with a female literacy rate of only about 22%. These rates are considerably behind the average levels attained in low-income countries and much behind those in Sri Lanka.

The Government should, therefore, continue to put in sustained efforts to upgrade its general education levels. At the same time, it should focus on improving the quality and standards of education, which have considerably deteriorated after independence.

3.6 Macro-economic Policy Situation

A sound and stable macro-policy framework is another important plank of a favourable investment climate. In recent years, Bangladesh has attained an admirable record of macro-policy management under the ESAP/PFP program of the IMF. Inflation has

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[15] World Bank, Report No. 10265-BD, loc.cit, p.115 and Report No. 9379-BD, "Bangladesh: Managing Public Resources for Higher Growth", April 19, 1991, pp 89-97 and 115-117.

been presently contained to a moderate one-digit level, down from 10 to 12 per cent of recent years. Continuation of this policy management at this very satisfactory level will remain important for the coming years. The keys to such policy management have been a more satisfactory level of public resource mobilization, containment of public expenditure in line with revenues raised and pursuit of cautiously managed monetary and credit policies. In future years, for improving public investment records which are at rather unsatisfactory levels, the Government will need to step up its efforts for increased mobilization of internal resources.

3.7 Public Enterprise Performance Situation

Public enterprises in Bangladesh continue to display a dismal record of financial performance. PE performance has greatly worsened in recent years, particularly in the jute and textile enterprises of BJMC and BTMC. Financial losses of certain public utility corporations such as PDB and Bangladesh Railway have also been very high. The staggering levels of public sector losses have not only imposed undue and unsustainable budgetary burdens on the Government, but also helped undermine the profitability and discipline in financial sector operations.

To grapple with this situation, the Government should expeditiously undertake and implement the restructuring reforms being formulated for the jute and textile sectors with IDA support. Plans for eliminating losses in other public enterprises should also be drawn up and implemented. At the same time, it will be very important to expedite the process of privatization of public enterprises within a well-defined time frame and a well-formulated strategy. As noted earlier, so long as retained public enterprises continue to be managed poorly, this will impact on the efficient operation and growth of private sector activities.

Annex 1

FIAS STUDY RECOMMENDATIONS ON THE LEGAL SYSTEM

1. Institute basic law reforms:

   a) Ensure greater autonomy and independence of the judiciary.

      * Repeal the amendments to Articles 115 and 116 of the constitution.

      * Establish a Judicial Appointments Committee

   b) Establish a Permanent Law Reform Commission.

      * Permit commercial legislation to be enacted in both Bengali and English.

      * Establish a cadre of professional legal draftsmen.

2. Modernize outdated commercial legislation

   a) Update the 1913 Company Law.

      * Simplify procedures for company formation.

      * Provide for reporting requirements to ensure transparency and provisions for the removal and liability of directors to ensure accountability.

      * Include minority shareholder protective provisions.

   b) Arrange for full enforcement of the 1909 and 1920 Insolvency Laws.

      * Establish director's liability for trading while insolvent.

      * Provide mechanisms, like the American "Chapter II" bankruptcy proceedings, to allow for the reorganization of companies.

      * Establish expeditious procedures with time limits for the payment of creditors and for winding up.

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* Include periodic reporting requirements with personal liability for making false or misleading reports and for the certification of such reports.

* Establish a Bankruptcy Bench in the Supreme Court.

c) To review the 1861 Admiralty Act, engage the services of an international lawyer specialized in Admiralty and Aviation Law to review and comment on the Corporate Laws Committee's 1990 draft revision recommendation.

d) To review the 1911 Patent Law and the 1960 Trademarks Act,
either resuscitate the now defunct committee established to re-examine the draft Trademarks Act and Patent Act submitted to the Government in 1990 or make this a priority matter for the proposed Permanent Law Reform Commission.

e) The 1882 Land Transfer and Stamp Acts and the 1908 Registration Act

* Reduce the registration fees and stamp duties on mortgages;

* Provide that the registration of instruments will be effective from the date of registration, not the date of execution;

* Reform and modernise the Land Registration Offices so that title to land and any encumbrances can be determined quickly, reliably and efficiently.

f) Leasing and Investment

* Amend the Banking Companies Ordinance to allow commercial banks to enter the leasing sector.

g) Labour Legislation

* Enact a new comprehensive Labour Code to rationalise the now applicable 47 different codes, ordinances, rules and regulations to provide an integrated framework for establishing the rights and duties of both employers and employees, and to provide seedy and effective access to justice for aggrieved persons. This should be another

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priority item for either the ad hoc commission for Examination of Labour Laws which was recently formed, or for the proposed Permanent Law Reform Commission.

h) Foreign Private Investment (Promotion and Protection) Act of 1980.

* Update the Foreign Investment Act to bring it in line with the changes made in the 1991 Industrial Policy Statement.

* Broaden the scope and interpretation of foreign investment.

* Include more transparent entry criteria, liberalize approval requirements and build-in incentives where relevant.

3. Reform of Judicial Administration Process and Law Enforcement

a) Give original side jurisdiction to the High Court division of the Supreme Court in cases involving more than Tk one million.

b) Increase the number of sitting Supreme Court Judges through the appointment of additional judges under Article 98 of the Constitution and provide them with the necessary court rooms, chambers and facilities.

c) Authorize the Chief Justice to implement a case management programme and provide funding to modernise court facilities and equipment.

d) Address the abuses of the judicial process:

* Assess costs on a progressive scale for repeated adjournments.

* Impose costs and discipline counsel for asserting senseless and frivolous defenses.

* Impose interest at 2% above commercial bank rate on awards in commercial legislation.

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* Require the posting of a significant percentage of an award to lodge an appeal.

e) Establish a Permanent Judicial Training Institute and a Practising Law Institute and provide them with the necessary facilities.

4. Reform of Administrative Procedures

a) Establish a Permanent Administrative Law Reform Commission to rationalize existing rules, regulations and procedures.

b) Establish a cabinet level Administrative Law Committee to vet all regulations and to ensure that they do not conflict with other regulations.

c) Reform administrative practices:

* Establish deadlines for action and institute automatic approval procedures.

* Establish in Inter-Ministerial Implementation Committee and an Administrative Law Tribunal.

* Publish rules, regulations and procedures; establish public reporting requirements; and publish a Handbook of commercial investment laws, regulations and procedures.

* Streamline anti-corruption procedures and appoint an Ombudsman as provided in Article 77 of the Constitution.

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