The Evolution of the Political Settlement and Productive Sectors in Bangladesh

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Relationships between Economic and Political Organizations

Formal Bureaucratic Organizations:
- High governance capabilities

Economic Organizations:
- High capability, mainly formal with significant surpluses

Political Organizations:
- Generally formal and rule-following rent seeking

- Legal transfers to political organizations ensure rent seeking aligned with interests of economic organizations
- Legal redistribution through tax system to powerful constituencies
- Formal rent seeking constrained within limits set by viability requirements of economic organizations

- Effective enforcement of formal rights
- Sufficient tax to finance formal enforcement/redistribution through budget

Advanced Countries
<table>
<thead>
<tr>
<th>Holding power aligned with enforcement of Formal Institutions</th>
<th>Formal Institutions Potentially Support Productive Organizations</th>
<th>Formal Institutions do not Support Productive Organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘Capitalist’ Political Settlement:</td>
<td>‘Capitalist’ Political Settlement:</td>
<td>Pre-Capitalist Political Settlements:</td>
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<tr>
<td>Formal productive rights dominate and associated incomes are the dominant source of holding power. Formal rights are well enforced.</td>
<td>Formal rights do not yet support many productive organizations. Powerful organizations generate incomes by informally modifying and enforcing rights. Formal rights consequently weakly enforced.</td>
<td>Variants of feudalism with formal land rights aligned with political-military power. Insufficient support for productive organizations made these settlements unviable.</td>
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<td>Significant sources of Holding Power not aligned with enforcement of Formal Institutions</td>
<td>Political Settlements in Crisis:</td>
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<tr>
<td>Formal institutions close to collapse. In extreme cases, informal ‘economic’ activity can be supported by the threat of violence or directly based on a war economy.</td>
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### Distribution of Power between Political Organizations

#### Horizontal Power of Ruling Coalition Relative to Excluded

<table>
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<tr>
<th>Ruling Coalition Organizations Strong</th>
<th>Excluded Organizations Strong</th>
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<tbody>
<tr>
<td>(Interests of Ruling Coalition Strongly Aligned with Growth)</td>
<td>(Interests of Ruling Coalition Weakly Aligned with Growth)</td>
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#### Vertical Distribution of Power within Ruling Coalition

<table>
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<tr>
<th>Higher Level Organizations Strong</th>
<th>Lower-Level Organizations Strong</th>
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<tbody>
<tr>
<td>(Ruling Coalition Has Strong Implementation Capabilities)</td>
<td>(Ruling Coalition Has Weak Implementation Capabilities)</td>
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#### Distribution Types

- **Strong Patrimonialism**
  - Strong Op. Eq. Possible with ‘Benevolent Authoritarianism’ of Developmental State
  - Effective developmental institutions including formal and informal disciplining of economic organizations. Op Eq with *Democratic* institutions possible in theory, with weaker disciplining. *Developmental States*: Taiwan 1950s, South Korea 1960s.

- **Vulnerable Patrimonialism**
  - Moderate to Weak Op. Eq. with ‘Repressive Authoritarian’ Institutions
  - Moderately effective development institutions but declining effectiveness as internal lower-level organizations become stronger; hence also limited lifespan. Quasi-developmental *Authoritarian Regimes*: Pakistan 1960s.

- **Constrained Patrimonialism**
  - Moderate Op. Eq. of ‘Dominant Party’ in Democratic or Authoritarian Settings

- **Competitive Clientelism**
  - Weaker development institutions than other scenarios. But stable Op Eq with democracy possible if institutions credibly allow cycling of competing parties and this can facilitate development. *Developing Country Democracy*: India 1970s- Bangladesh 1980s-, Thailand 1980s-1990s
The growth acceleration of the 1980s

- Economic growth accelerated across South Asia around 1980

<table>
<thead>
<tr>
<th>Growth Rates %</th>
<th>India</th>
<th>Pakistan</th>
<th>Bangladesh</th>
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<tbody>
<tr>
<td><strong>GDP</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1960-80</td>
<td>3.5</td>
<td>5.5</td>
<td>1.7</td>
</tr>
<tr>
<td>1980-90</td>
<td>5.6</td>
<td>6.1</td>
<td>3.6</td>
</tr>
<tr>
<td>1990-00</td>
<td>5.8</td>
<td>3.7</td>
<td>4.7</td>
</tr>
<tr>
<td>2000-05</td>
<td>6.7</td>
<td>4.9</td>
<td>5.3</td>
</tr>
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<table>
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<tr>
<th>Per Capita GDP</th>
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</thead>
<tbody>
<tr>
<td>1960-80</td>
<td>1.2</td>
<td>2.6</td>
<td>-0.8</td>
</tr>
<tr>
<td>1980-90</td>
<td>3.4</td>
<td>3.5</td>
<td>1.2</td>
</tr>
<tr>
<td>1990-00</td>
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- A similar evolution of the political settlement characterized all these countries: populist authoritarian dominant parties broke down in the mid-1970s (Indira’s Emergency, Mujib’s one-party state, Bhutto’s PPP)

- Capacity of state agencies to enforce discipline did not improve but the ability of anti-business interests to oppose explicit support to capitalists also declined
Understanding growth processes with competitive clientelism

- Previous industrial policy strategies in South Asia had enabled horizontal expansion of industries but without productivity growth because discipline could not be imposed on capitalists.
- Even with vulnerable or constrained patrimonialism there were so many political organizations that business interests could always buy protection at a cheap price.
- The development of a competitive clientelist configuration led to a period of crisis as political institutions adjusted: eventually variants of democracy emerged that were in vulnerable equilibrium with competitive clientelism.
- Under the clientelist authoritarian rule of managed democracy under Zia 1977-81 and Ershad 1981-90 policy orientation changed towards explicit informal and formal support for businesses with kickbacks to political leaders.
- The emergence of a competitive political system 1990- sustained this pattern.
- This type of ‘business-government’ relationship can obviously lead to huge political corruption and waste and did in many sectors but in a few sectors it also led to growth in the presence of specific conditions.
The rise of the garments industry

- The dramatic growth of the labour intensive garment industry in Bangladesh in the 1980s and beyond is often portrayed as a proof of the efficacy of liberalization and market-driven comparative advantage.
- But Bangladesh had low wages before 1980.
- The emergence of a globally competitive sector required the accident of the Multi-Fibre Arrangement or MFA (set up in 1974, protecting US garments and textile manufactures from competition from established producers).
- This allowed existing managerial and entrepreneurial capabilities to be upgraded in sectors where learning still had to be financed.
- The MFA set China, South Korea, Turkey, and other established garment and textile countries quotas on US imports, and as a way of getting the support of other developing countries, it offered quota-free access to countries like Bangladesh that had no garment industry at all.
- Result was ‘quota rents’ for Bangladesh, enabling it to sell at a higher price in world markets and thereby finance a period of learning by doing.
The initial takeoff was based on a single company called Desh Garments which entered a collaboration with the South Korean Daewoo in 1979.

Daewoo was involved in textile and garments but its garment activities were now blocked by MFA: it needed to sell the textiles but to an offshore partner.

The founder of Desh was an ex-bureaucrat who had accumulated millions of dollars in Bangladesh’s period of rapid primitive accumulation in the 1970s.

In the 1980s the military-backed government of Zia-ur-Rahman wanted to support industrialization and Zia assisted the collaboration significantly.

No evidence that Zia personally benefited, but his support was personalized: he spoke to Daewoo’s head and promised to assist in overcoming bottlenecks.

The capital investment was entirely by Desh.

Desh essentially purchased know-how (learning) from Daewoo: Daewoo would host more than a hundred Bangladeshis at its factory in Pusan who would learn on the floor aspects of modern garment manufacturing.

The cost of hosting would be borne initially by Daewoo but they would be paid back in the form of an eight per cent royalty on sales eventually made by Desh.
Thus the learning rent came from a combination of the MFA and an initial investment by Daewoo but Daewoo had a very strong incentive to put in high levels of effort to ensure that learning took place: it needed to sell its textiles to Bangladesh, and it needed to recoup its investments in learning through the royalties.

On the other hand, the Bangladeshis who went to Pusan had a strong incentive to learn because this was their first exposure to global production: Of the 130 mid-level managers who went to Pusan for Desh, 115 eventually set up their own garment factories.

Desh had planned for a 5 year collaboration with Daewoo, but so successful was the learning that the deal could be terminated after less than 2 years.

Desh’s growth and that of the Bangladesh garment industry was explosive: Desh grew at around 90 per cent a year between 1981 to 1987.

The accidental design of formal incentives here was such that no powerful political organization could offer to mediate a reallocation of rents using informal power: neither the MFA nor the upfront investment by Daewoo were amenable to influence.
Bangladesh’s garment industry: Learning using MFA rents

- Zia pushed through institutional innovations like the back-to-back LC and effective bonded warehouses.
- The Bangladesh garment industry grew from a zero base in 1980 to around 3500 firms in 2005 employing 3 million workers and generating 70 per cent of exports.
- The sector still enjoys double-digit growth.
- Raegan imposed quotas for Bangladesh as early as 1985, just a few years after Desh.
- Bangladesh’s manufacturing sector now has a similar share of GDP as India, but is focused largely on low technology sectors.
- The challenge for Bangladesh is to move up the value chain in the garment and textile industry.
- Upgrading is happening through individual entrepreneurs with deep pockets investing in backward linkages but absence of financing for learning has constrained upgrading.
- Visited higher technology garments factories in Bangladesh earlier this year: quiet upgrading is happening largely based on own pockets: absence of institutional or political support.
Promising new sector is electronics and light engineering. Pioneering role of Walton. Again own investment story: set up in early 1980s as trading company. Now makes fridges (almost 100% local except for compressor) and motorcycles (60% local).

Advertises as ‘Made in Bangladesh’

Shamsul Alam, one of the owners told us their ambition is to manufacture the first Bangladeshi car as a development project to spread knowledge of engineering across Bangladesh.

Also assembles TVs and air conditioners.

Followed by Butterfly which is moving into co-production with Chinese and Transcom Electronics which says it is forced to manufacture fridges after Walton reduced the local price.

Detailed discussion with manufacturers revealed quite a lot of participation in policy-making on tariff rates.

Consensus that if you have your own money to invest politicians leave you alone, but don’t expect assistance from the state.
Power is at a crunch point

- The paradox of growing political factionalism and conflict with apparent non-intervention in businesses financed by private money tells us that the conflict over rents is taking place in other areas: land grabbing, government contracts, infrastructure building projects.
- Conflicts within ruling party and with opposition frequently lead to deaths.
- Businesses use political organizations for minor contract enforcement and for land purchases: direct expropriation of business is relatively rare.
- Elections are always vulnerable and a Constitutional Amendment has ended the Caretaker System in Bangladesh: the opposition says it will not contest next election.
- In this context, power shortage is costing 2% of potential economic growth.
- 4500MW capacity while peak demand is 5800MW. Current government promised to add 7000MW but unlikely to add more than 2150MW and that too mostly very expensive rental power plants.
- No major plant has begun to be constructed though three large plant contracts have been handed to one company: Summit Power, belonging to the brother of the Commerce Minister.
Competitive Clientelism Constrains Power Sector

1. Projected Rapid Growth of IPP and Foreign Participation in Energy Sector

2. Risks of future government insolvency, inadequate fuel supplies and contract enforcement in general

3. Increased risk for bidders because of corruption

4. Investments in relationships required to mitigate risks

5. ii) High Financing Costs
   - High risk premiums
   - Doubts about long-term ability of government to pay

6. iv) Procurement Rents more attractive than Production/Distribution Rents

7. v) Protracted decision-making and high chances of blocking by losing factions

8. vi) Very few successes in IPP investments

9. High-cost successes raise risks of future government default

Adverse selection

Upfront rents result in intense competition within party and bureaucracy
Challenges for the Future

- Political stability depends on a live-and-let-live informal agreements between parties: not yet established.
- Financing learning could pay rich dividends in sectors where serious companies like Walton already exist. Potential role for private banks to finance learning but they are constrained by contract enforcement.
- But if they can make recovery arrangements that are credible, it seems that political factions are rarely explicitly predatory on small firms.
- The real economic costs of competitive clientelism are in infrastructure and power investments where political competition raises risks and creates incentives for upfront rent capture: this sets off a vicious cycle where no significant investments take place. Good governance strategies and rule of law do not work: long term credit may change the incentives of serious investors if external agency can govern the lending.
- New factor with India’s interest in its North-East may further destabilize politics: rents to ruling party have destabilized internal balance of power.