Policy Brief

Promoting inclusive growth in Bangladesh through Special Economic Zones[*]

Introduction

Eradicating poverty by accelerating economic growth and generating employment opportunities through industrialisation is a key policy priority for Bangladesh. The Government of Bangladesh has decided to establish 100 Special Economic Zones (SEZs) for creating 10 million jobs and generating an additional $40 billion of exports. By offering attractive fiscal and financial incentives, and serviced industrial plots, these economic zones are expected to mobilise investments from both domestic and foreign sources. The Seventh Five Year Plan of Bangladesh (7FYP) intends to use SEZs as a policy tool for inclusive growth by promoting development in lagging regions within the country.

Regions in Bangladesh exhibit significant differences in many respects including in terms of location and distribution of economic and industrial activities. For example, employment-intensive manufacturing and export-oriented enterprises are largely concentrated in greater Dhaka and Chittagong regions. Should SEZs aim to attract similar investment projects in lagging regions? Will SEZs in disadvantaged regions generate inclusive growth while not affecting overall economic growth? The experiences of developing countries with SEZs are mixed. One challenge for Bangladesh is therefore to ensure effectiveness of SEZ policies.

Regional inclusivity and the role of policy

While the idea of using economic zones for regional development is an appealing one, policy-makers have to confront a trade-off between balanced spatial distribution economic activities and the benefits of agglomeration economies that tend to concentrate industrial production in a few existing growth poles.

The 'new economic geography' model, developed by Nobel prize-winning economist Paul Krugman, is the most powerful analytical framework to demonstrate how clustering forces generate an uneven distribution of production and income across space. The ensuing agglomeration effects arise from the interactions amongst scale economies, cost advantages (including trade costs) associated with geographical locations, factor price differences, etc. Because of these factors, economic regions with higher production activities will be more profitable and will therefore attract even more firms.

Some argue that while private sector firms will tend to concentrate in existing growth centres, state-owned industry location decisions consider regional balance, national security, and political gains. However, as the role of the state has been substantially diminished under policy liberalisation and structural reform programmes, industries are likely to be more spatially concentrated. China offers an example of extensive interventions in addressing regional inequality, diverting economic activities from the coast onto the interior regions.

Spatial variation of development in Bangladesh

In Bangladesh, there is a general perception of socioeconomic conditions in western districts lagging their eastern counterparts. This was first formally highlighted in a World Bank study by the, which found the pace of poverty reduction during 2000-2005 to be much slower for western districts. Several unfavourable characteristics of western regions were put forward to explain this 'east–west' divide: lack of connectivity, lower remittance incomes, inadequate public infrastructure, etc. A subsequent official household survey in 2010 showed a reverse trend, thereby suggesting narrowing of the earlier
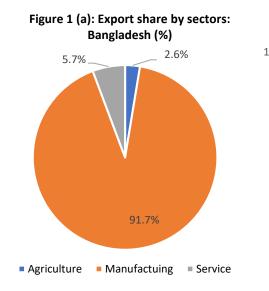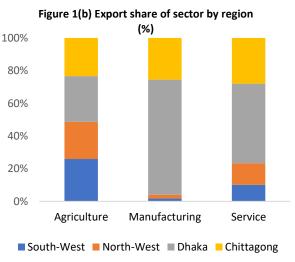
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divergence. The latest survey, in 2016, seems to suggest poverty reduction for the western districts on average is likely to have been slower.

Various studies have discussed other types of disparities, such as those in income and educational attainment at different regional levels (e.g. divisional, district and sub-district levels). While localities with disproportionately unfavourable outcomes can be found in any part of the country, there seems to be a general consensus that at higher administrative division levels the western part of the country (comprising the divisions of Barisal, Khulna, Rajshahi, and Rangpur) is lagging behind its eastern counterpart in most socioeconomic indicators.

One problem in capturing regional disparities and understanding the impact of any relevant policy options is data deficiencies. There is a lack of sufficiently disaggregated data at regional levels, coupled with the problem of information from different sources being available for different time periods and often using different survey methodologies. It is therefore a foremost necessity to construct a consistent data framework. This can conveniently be done utilising a Social Accounting Matrix (SAM), a salient feature of which is to bring together macroeconomic data (such as national income accounts) and microeconomic data (such as household surveys) showing linkages amongst sectors, institutions and activities.

When a regional SAM is constructed, dividing Bangladesh into north-west, south-west, greater Dhaka and greater Chittagong regions – in line with the east–west divide mentioned above – it is found that the greater Dhaka and Chittagong (eastern) regions together account for 87% of the country's manufacturing gross domestic product (GDP) in 2015. As manufacturing constitutes about 92% of Bangladesh's exports, virtually all of it comes from these two regions only. Even in agricultural exports, the combined share of the north-west and south-west regions (52%) is just marginally higher than that of the Dhaka and Chittagong regions. Overall, more than two thirds of GDP came from the eastern region.

Figure 1 (a): Export share by sectors: Bangladesh (%)

Figure 1(b) Export share of sector by region (%)

Source: Based on authors' data work

Potential impact of SEZ activities in lagging regions: experimental policy simulations

Although the SEZ development work is at an early stage, it would be useful to undertake some experimental policy simulations to consider the likely impact of new economic zones.

Simulation scenario (1) – export growth of SEZs based on the existing regional production structures: As the SEZ policy aims to achieve $40 billion of additional exports by 2030, and given the current regional production structures, an overwhelming majority of export production takes place in greater Dhaka and Chittagong regions with a modest boost for economic activities in the north-west and south-west regions due to backward and forward linkage effects. Bangladesh's GDP rises by 5% as against a 3% output growth from the north-west and south-west. The poverty headcount ratio falls by 1.6 percentage points in the north-west and by 3.2 percentage points in the south-west. A total of 3.4 million jobs are created, of which just over 1 million are in the north-west and south-west regions. Overall, there are an additional 1.1 million jobs for women. Of these, 0.31 million are in western districts.

In **simulation (2) – export growth with enhanced participation of north-west and south-west regions in manufacturing activities –** $20 billion exports (of ready-made garments and leather) are generated from the north-west and south-west (as a contribution towards the target of $40 billion additional exports). This results in massive growth of manufacturing output (by 15% and 20% in the north-west and south-west, respectively). These two lagging regions benefit from 1.28 million additional jobs, of which 0.43 million are for women. The poverty headcount ratio for the north-west declines by 3 percentage points while the corresponding fall for the south-west is 5.6 percentage points.

How different types of households participate in economic activities can give important insights into the inclusivity of growth. In simulation 1, most additional production is due to the greater Dhaka and Chittagong regions, but still households in backward regions increase their supplies of labour. However, given increased SEZ production under simulation 2 in north-west and south-west regions, small farm and non-farm households in both the regions and lower-skilled households in north-west districts experience much higher demand for their labour. These households are known to make up much of the vulnerable and excluded groups, and consequently they seem to benefit from the increased SEZ activities in backward regions. The overall growth impact under simulation 2 is slightly higher, and thus there is no growth compromising effects of regionally targeted SEZ policies.
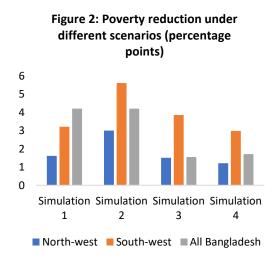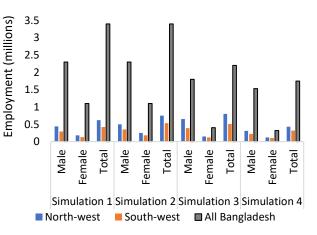

Figure 2: Poverty reduction under different scenarios (percentage points)
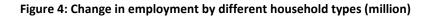

Figure 3: Employment generation (millions)

Simulation scenario (3) – export boost of agri-processing from north-west and south-west regions: It is widely regarded that the north-west and south-west regions are more suited for agricultural production. When a $20 billion agri-export demand shock is generated for these regions, the overall growth impact in the country is 1.65%. This comes with the generation of 2.2 million jobs: 1.31 million for the north-west and south-west districts including 0.27 million women's jobs. Finally, under
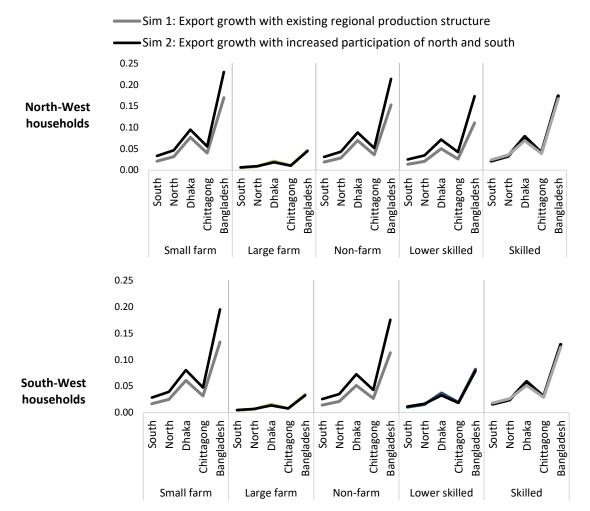
simulation (4) – SEZs-led investment push – if SEZs lead to doubling investment, the national GDP rises by 2.35%, creating 1.75 million jobs, leading to poverty reduction by 1.71 percentage points.

It is important to point out that the policy options are not mutually exclusive; i.e. a combination of the scenarios would be feasible and more appropriate. A mix of scenarios 2, 3 and 4 would be most practical in addressing regional inclusivity.

Figure 4: Change in employment by different household types (million)

Note: The figures show changes in labour supplies to different regions from different types of north-west (above) and south-west households.
Source: Authors' simulations

SEZ development work in progress and regional inclusivity

Bangladesh Economic Zones Authority (BEZA) aims to establish SEZs in all potential areas 'including backward and underdeveloped regions' (BEZA annual report 2016, p.19). However, it is not elaborated how these regions are being identified. Of the 79 zones that have so far been officially selected, only 20 (about 25%) are in north-west and south-west Bangladesh. Of the 20 private economic zones, all but two are in Dhaka and its surrounding districts. As many as 18 zones in the north-west and south-west along with another 21 zones in Dhaka and Chittagong regions have yet to see any on-the-ground SEZ-related work.

On-the-ground progress of SEZ development work can be evaluated using the status of four key milestones: (i) land acquisition, (ii) preparation of a feasibility study, (iii) infrastructural development and (iv) investment for industrial units. An index that gives equal weight to each of the four milestones would reveal that development in the north-west and south-west regions is much slower.

SEZ-led regional development: issues for further consideration

The simulation results above are quite encouraging about the potential impact that SEZs can have on overall output, employment generation and poverty reduction. However, the lagging regions may be subject to certain inherent limitations, yielding less-than-expected outcomes. Bangladesh's experience with export processing zones (EPZs) already provides hints in this respect. Three of the eight EPZs are in lagging regions. In terms of investment attracted and employment generated, the performance of these three is relatively weak. Particularly, the one in Mongla with easy access to a seaport has the least investment and smallest workforce employed.

There are several other factors that must be taken into serious consideration to make SEZ-led policy work effectively.

- **A clear SEZ development strategy to address regional inclusivity is of utmost importance.** The alignment of the vision in the 7FYP and on-the-ground implementation work will require careful identification of lagging districts and prioritisation of SEZ development in these regions. In stating the ambition of generating $40 billion additional exports from SEZs, incorporation of one such target from lagging region zones could be helpful. That the national development framework aims to use SEZ as a policy tool for addressing regional disparities needs to be reflected in the zone development work programme.

- **To be a meaningful pull factor, economic zones in lagging regions must offer incentives that do not exist elsewhere or are significantly better than existing ones.** The perceived costs of doing business in these regions are much higher, and investors need to be convinced that incentive margins will at least help offset the extra costs of being located in relatively remote regions.

- **In the presence of a plethora of industry support systems, coordination amongst institutions will be critical.** Also, it is important to strike a balance between industrial growth that takes advantage of the growing domestic economy, and growth achieved through an export-led growth strategy. If SEZs are going to be dominated by firms aiming for local sales only, the policy incentives as well as a highly protected trade regime, as highlighted in the 7FYP, could help inefficient production units to flourish, with adverse welfare consequences.

- **Using agglomeration economies while focusing on regional inclusivity should be given serious consideration.** SEZs in lagging regions could suffer from lack of critical mass in attracting firms and investments and creating enough positive spillover effects. Developing too many sub-optimally sized economic zones can also undermine the benefits of economies of scale and externalities. The development of Mirsarai-Feni industrial city could closely resemble the kind of growth centres needed in the north-west and south-west regions for exploiting agglomeration economies.

- **Developing lagging-region SEZs as part of economic corridors is important.** An economic corridor is envisaged in Bangladesh running from the south-west region of Bangladesh (Khulna Division) to the north-east region of Bangladesh (Sylhet Division) via Dhaka. This can help integrate south-west SEZs with more productive and leading SEZs, particularly in Dhaka. Bangladesh is also pursuing transport connectivity with many Asian countries under various regional initiatives. If they help promote intra-regional trade, investment, and movement of goods through land borders, some of the currently lagging regions in Bangladesh will benefit immensely.

- **Appropriate, adequate and well-functioning infrastructure cannot be overemphasised for SEZs, and more so in lagging regions.** There is cross-country evidence to suggest that infrastructure reliability has a greater impact on SEZ success than other policy incentives. Without the provision of elaborate and functional infrastructure, SEZs in lagging regions would be regarded as a poor choice of location.

- **Ensuring fair access to entrepreneurs, including small and medium-sized enterprises, is extremely important.** Land is very scarce in Bangladesh, and serviced industrial plots are even scarcer. In many other developing countries, political economy factors are often used in accessing privileges that SEZs confer, including access to cheap land and fiscal incentives.

- **Existing opportunities for maximising synergies between EPZ and SEZ regimes should be exploited.** By eliminating the restriction on domestic firms' participation, SEZs can potentially boost the possibilities of developing backward linkage capacities directly targeted towards the firms within the same premises. Greater interactions between local and foreign firms will give domestic enterprises better exposure to modern production techniques and management practices. One consideration could be to allow local firms to participate in three EPZs in north-west and south-west Bangladesh. Investment and export response from these establishments have been subdued so far, and opening them to local firms based on SEZs modalities could generate momentum in these lagging regions.

- **Ensuring availability of skilled manpower would be a challenge for SEZs, particularly in relatively backward regions**. The 7FYP has explicitly suggested supporting lagging regions with skill development, such as by establishing technical and vocational institutes. Implementation of this vision is extremely important. In addition, civic amenities, recreational facilities, and good housing and accommodation will be required to help skilled workers relocate.

- **Assessing costs and benefits for any ambitious project like SEZs is important for learning lessons, introducing innovative policy designs and evaluating opportunity costs associated with alternative options.** Cross-country studies suggest that, more often than not, economic zones produce much less than expected outcomes. Policy experiments to evaluate the likely impact of different types of investment projects, particularly for ensuring regional inclusivity, are also issues for consideration while assessing costs and benefits.

- **Many other general factors that determine the success of SEZs will also be relevant while considering regional inclusivity.** Effective institutions, sound and enforceable legal frameworks, transparent decision-making processes, a business-friendly investment climate, simplified administrative and bureaucratic processes, improved trade facilitation etc. are essential preconditions for promoting industrial growth.

- **Finally, there is a need for quality data on a regular-interval basis to analyse issues of regional disparities for developing suitable policy options.** In the immediate term, it will be extremely helpful to develop a consistent data framework to capture district-level outcomes associated with incomes, social indicators, poverty incidences, and sectoral interlinkages. This will then allow policy experiments to study impact at the district level. Ideally, efforts should also be made to build at least a few sub-district-level (including some for lagging regions) analytical models, to be able to understand the differential effects of different policy options.

Conclusion

Development of SEZs and making them growth poles for generating employment opportunities are challenging endeavours – and more so for addressing regional disparities. There are valuable cross-country experiences and best practices that must be carefully studied to derive lessons for Bangladesh. As the country is in the early stages of zone development, it is most timely to review them and take appropriate policy measures.