CHAPTER 1

Conceptual Framework*

Introduction

The 2015 Report on *Human Development in South Asia* is appropriately focused on the theme, 'The Economy and the People'. The year 2015 marks the 25th year of United Nations Development Programme's (UNDP) *Human Development Reports* whose focus on human development is seminal to policy, research and advocacy activities world-wide. The year also marks the 20th year of the Mahbhb ul Haq Human Development Centre, a policy research institute and a think-tank set up in 1995. With a special focus on South Asia, the Centre has continued to promote the human development paradigm as a powerful tool for designing people-centred development policy at the national and regional level. This year also marks the 15th year of the Millennium Development Goals (MDGs), which laid out an ambitious development agenda in 2000 to address global development challenges. As the world advances to a post-2015 global compact, the need to critically assess the impact of policies on people is timely, especially in South Asia where the economies have done well over the last decades.

The achievement of economic growth has to be judged in terms of its impact on the lives and well-being of people. Besides an increase in gross national product (GNP), there is also a need to improve the character, structure and quality of growth to ensure that it is directed to empower people, reduce poverty and protect environment. As Mahbub ul Haq asserted, there is no automatic link between economic growth and people's empowerment. These links must be forged with policies and strategies so that they are mutually reinforcing; only then would economic growth effectively and rapidly improve people's well-being.

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The policy makers have to recognise the two-way relationship between economic growth and expansion of human capabilities. While economic growth generates resources to expand education, health, and other indicators in social sector, the expansion of human capabilities contributes to faster economic growth. This two-way relationship has been a central strategy for miraculous development in Japan, South Korea, Taiwan, Thailand and in China, making these countries world leaders in expanding economic growth and human capability.

South Asia does not have such a two-way relationship. There have been failures to foster the kind of growth that enhances people's living conditions. Economic growth has been robust in South Asia during the last few decades, making it one of the fastest economically growing regions in the world. Yet despite impressive economic growth, South Asia contains a huge number of poor people and malnourished children, inefficient health systems, inadequate education system, and 62 per cent (in 2010) of people without any access to sanitation facilities.[1] There is inadequacy of essential services such as safe water, electricity, drainage, transport, etc. In the long run this inadequacy of social and physical infrastructure, and the poorly educated and trained workforce, will threaten the pace of economic growth. Why is there such delink between economic growth and people's well-being in South Asia? That is what we try to understand in this Re-

*: This chapter has been drawn on the comments of Shahid Javed Burki on the concept paper prepared by Khadija Haq.

port by analysing the political economy of South Asia—we assess the links between politics, economics and human development in order to understand the current situation in South Asia.

An overview of the political economy of South Asia

To carefully assess South Asia's poor human development record in view of the region's recent record of economic growth, one must look beyond the region's economic growth policies to analyse the political economy of the two largest South Asian countries—India and Pakistan. There are reasons that are not fully understood why all the accumulated knowledge based on Mahbub ul Haq's work did not get translated into public policy in South Asia.

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The 2014 Indian election has vividly pointed to what we would call the great 'South Asian paradox'. But India was not alone in this respect. In fact what it has shown was demonstrated with equal clarity by the May 11, 2013 elections in Pakistan. Then in Pakistan and now in India three features in the South Asian politico-economic landscape become highly visible. First was the rise of the large middle class which has happened as a consequence of the combination of a number of circumstances. Demography was one of the several reasons for the increase in the number of people who can be classified as belonging to this large segment of the population. The region with a median age of 25 years has more young people than any other regions in the world. Of the current population of 1.67 billion (in 2013) in mainland South Asia, 820 million are below the age of 25 years.[2] It is also the most rapidly urbanising area in the world. By 2015, 51.5 per cent of the area's population—some 1,189 million people—will be living in towns and cities.[3] The growth in the size of the middle class also resulted from a significant increase in the rate of economic growth. This was the case more in India than in Pakistan. Also contributing was the massive inflow of finance into poor households from the South Asian workers in the Middle East. Remittances resulted in the graduation of hundreds of millions of people from poverty to lower middle class status. These remittances were sent by people who lived in construction ghettoes in the Middle East in order to lift their people out of poverty. Having faced the harsh conditions in the Middle East they aspire better lives for their families and for themselves when they return home.

The second reason was the perception on the part of the lower middle class that the state was not working for their betterment. The Indian 'distributive state' coupled with bureaucratic red tape and pervasive corruption created a big gap between aspirations and realisation. This was also true for Pakistan although Islamabad did not commit as large a proportion of national income or public expenditure to subsidies meant for the poor and the lower middle class as did India. This class became increasingly frustrated with its situation. What it did not gain in economic terms—a significant share in national income—it was able to acquire in the political arena. However, it was only during elections that the disgruntled could get their voice heard.

Third, technology and its spread have given tools to this class that were not available to groups such as these in times before and in other places. The members of this class were able to share their growing frustration with the work of the state with their cohorts. Individual experience became collective and shared beliefs.

These are some of the factors that are behind the political revolution in two major states of South Asia—India and Pakistan. In the past developments such as these produced revolutions led by the left; this time the leadership was provided by the right. In the Nehru-Gandhi India and Zulfikar Ali Bhutto's Pakistan, the power of the state was used in the attempt to satisfy the aspirations of those who were left behind. These attempts clearly failed. This is the main reason for the collapse of the left-leaning parties in Pakistan and India. In Pakistan, the Pakistan People's

Party lost heavily. The same happened to India's Congress Party. Nehru drew his inspiration from the Soviet Union and used Lenin's phrase—*"putting the state on the commanding heights of the economy"*—to design an approach to economic development that produced what the Indian economists themselves called the 'Hindu rate of growth'. For more than four decades after independence, the Indian gross domestic product (GDP) increased at an average annual rate of 3.5 per cent. Bhutto turned to China for his model of economic development and drew the same conclusion as did Nehru but used a very different strategy for achieving it. Nehru mobilised domestic savings and turned them over to government institutions for increasing the presence of the state in the economy. He also used the government's power to control the working of the private sector. The latter led to the creation of the 'license raj'. Bhutto followed the Maoist approach to use expropriation to expand the state's role. Both believed that an economically powerful state was needed to deliver the poor and under-privileged their unmet basic needs. The sharp increase in the share of the state in the national economy in Pakistan produced the same result as in India. The rate of GDP growth declined by about a half compared to that achieved during the 11 years of Field Marshal Ayub Khan.

It was the push-back of the state in the early 1990s in both India and Pakistan that increased the rate of economic expansion. This burst of economic energy lasted for about a quarter century. Pakistan's growth spurt lasted for a much shorter period since the Indian fundamentals—in particular the rates of domestic savings and investment—were much more robust than those of Pakistan. But later economic growth stalled in both countries and produced the political convulsions noted above. Both the Pakistan Muslim League (N) of Nawaz Sharif and Bhartiya Janata Party of Narendra Modi promised the same approach to economic revival. Their electoral programmes and speeches used the same approach to attract voters to their side. There was to be economic growth, improved governance, better provisions of public goods, large investments in infrastructure and jobs for the youth. The energy of the private sector was to be mobilised to lead the economies out of stagnation towards buoyant growth.

The disgruntled elements in the two countries bought the message; many of them switched sides from the populism of the left to that of right. Thomas Friedman of *The New York Times* has called this group the 'Square People'. They are the *"newly connected and aspiring middle classes who have gathered in the squares from Cairo to Kiev, Istanbul to Tehran, and Tunis to Moscow to demand a greater voice in their future and for better governance. A lot of leaders are discovering that these Square People are like a spontaneous third party that has emerged between themselves and their tame traditional opposition, and as a result, their politics is getting a bit crowded…Indeed, 'The Square'—as the place for these newly networked political forces to gather, collaborate and pressure for change—is truly disrupting both traditional politics and geopolitics. But the big thing to watch going forward is which Square People can go from disruption to construction—can take the energy and inchoate aspirations of their Square followers and turn them into parties, elections and better governance."* [4]

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In the case of India and Pakistan, the 'Square People' description can only be applied metaphorically. Those who voted out the old order and ushered in a new one did not gather at a public place but under the tents of established political parties. They will stay there only if the parties they have chosen to place in power can deliver what they, the people, expect. This leads us to the question whether the models presented in barest outlines to the people by the parties and the leaders who won these elections will deliver the results that are expected. If this question were to be posed to Thomas Piketty, the author of the book *Capitalism in the Twenty-First Century*, the answer will be 'probably not'.[5] In giving that answer Piketty has history on his

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side. Using data collected admittedly from the countries in the developed world, the French economist shows why there is inherent tendency in the type of capitalism promised by Sharif and Modi to take the countries in which it is practiced towards extreme inequality. Piketty's arithmetic is simple. Over time output per person—productivity—trends to increase at an average of 1.0 to 1.5 per cent. On the other hand, average return on investment over long periods of time ranges between four to five per cent. Compound the difference over time and we begin to see why the top one to five per cent has accumulated much of the incremental wealth leaving little to be shared by the vast majority of people who only have their labour to invest in the economy.

There is of course another way and that is to invest in human development, and thus increase the rate of growth in productivity. This will require an active and honest state—a state that is able to collect a much larger share of incomes of the rich in order to improve the human capital of the poor. Piketty's prescription is an annual global tax of up to 2 per cent combined with a progressive income tax rates as high as 80 per cent (on income of US$500,000 to one million a year in the US). Will the Sharif and Modi governments be able to go anywhere near these levels of taxes, especially when they are beholden not only to the Square People but also those who want unconstrained capitalism to prevail?

Link between politics, economics and human development

With this background in mind, we try to assess the impact of South Asia's economic policies on people's empowerment.

Economic growth normally expands employment opportunities and increases wages. However, this does not happen automatically. A strong link between economic growth and employment creation requires the formulation of employment generating policies. The evidence can be seen from East Asia. The sustained long-term growth in East Asian countries expanded employment and raised productivity. This growth was led by small-scale agriculture in Taiwan and by labour-intensive export-oriented manufacturing in Hong Kong, the Republic of Korea and Singapore. South Asia, on the other hand, has recently faced the situation of jobless growth. Despite high economic growth, majority of the people have been unable to find remunerative work and hence are engaged in either low productivity farm sector or informal work. The growth process has bypassed the youth, the women, the unskilled and the minorities. Around 60 per cent of the population (in 2013) is under the age of 30.[6] These young people could be considered a demographic dividend if they are provided with adequate education, health and employment. Considering the fact that the region will add 1.0 to 1.2 million new entrants per month to the labour force during the next two decades, the region has to focus on employment generating policies.[7]

The provision of quality education and healthcare is critical in fostering economic growth and in ensuring that growth leads to rapid improvements in people's living conditions. During the recent periods of economic growth in South Asia, some people have done extremely well, but a large majority remains deprived of basic necessities. It is not the case that their lives have not improved at all, however the pace of improvement has been either slow or inadequate to make a difference. Some countries and states/provinces in the region have performed well such as Bangladesh and Sri Lanka and the states of Kerala, Himachal Pradesh and Tamil Nadu in India, and the province of Punjab in Pakistan. However, overall the state of education and health remains dismal. According to Amartya Sen and Jean Dreze's book on *An Uncertain Glory: India and its Contradictions*, Bangladesh despite low per capita GDP has performed reasonably well in terms of improvement in social indicators than countries like India and Pakistan.[8]

Women are among the groups facing discrimination and deprivation. However there have been success stories. For instance, in Bangladesh girls and women have been rapidly educated and are involved in the expansion of basic education, healthcare, family planning and other basic services as well as being a big part of the industrial labour force. This experience shows that other countries of the region can also empower women.

The region has to increase economic growth. It also needs to focus on the character of the growth process, including its equity and sustainability. New mechanisms must be created to help the weak and the vulnerable to benefit from the opportunities of the new economy. The agenda for achieving the new patterns of people-centred growth must include:

- Accelerating economic growth to improve human development with special focus on education, health and population control;
- Ensuring the long-term sustainability of growth by giving more attention to poverty reduction and people's empowerment;
- Formulating employment generating growth strategies to ensure inclusion of women, youth, uneducated, unskilled, minorities and disabled;
- Increasing regional trade and access to global markets to boost employment opportunities; and
- Setting up safety net programmes to reduce poverty and achieve a more equitable development.

Objective of the Report

The objective of the 2015 Report is to assess the economic policies against social development in South Asia over the last three decades—1980 to 2010.

During the last half century, there has been significant economic growth in South Asia. GDP per capita has almost tripled since 1980. All three major sectors—agriculture, industry and services—have experienced higher growth rates. In particular, the service sector has expanded greatly. While the contribution of agriculture has decreased steadily over the years, the industrial and service sectors have become major contributors to South Asian economies. Significant productivity gains have accompanied these structural transformations. Across the board, there have been improvements in output per worker.

These gains are also reflected in the region's increasing shares in certain world markets. South Asia is one of the world's largest exporters of textiles and is able to compete in the world markets. In addition, the region is diversifying rapidly into high-technology markets, such as computer software and other information technology-enabled sectors (ITES). Bangalore, for example is the largest software export centre.

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In the 1990s, the globalisation process in South Asia was initiated to accelerate economic growth through enhanced internal and external competition, privatisation and trade liberalisation. Yet despite the implementation of economic reforms programmes, economic growth in South Asia has neither been adequate nor progressive enough to reduce poverty or significantly reduce income inequality, or improve human development.

The trend in human development indicators in the region shows much progress compared to initial conditions. In 1980, the average life expectancy in South Asia was 55 years, which had gone up to 66 years in 2010. Similarly, combined gross enrolment ratio went up from 38 per cent in 1980 to 66 per cent in 2011. Adult literacy rate also went up from 39 per cent in 1981 to 61 per cent in 2011. Infant mortality rate went down from 117 per 1,000 live births in 1980 to 48 in 2010. Real GDP per capita also went up from US$295 in 1980 to US$940 in 2010.[9]

The Human Development Index (HDI) of South Asia has improved from 0.365 in 1980 to 0.562 in 2010.[10] In 1990, while Sri Lanka was among the 'medium human development' countries, Bangladesh, India, Pakistan and Nepal were among the 'low human development' countries in the world.[11] By 2010, Sri Lanka, the Maldives, India and Pakistan were among the 'medium human development' countries.[12]

Yet, colossal human deprivation pervades the region. Compared to initial conditions, much progress has been made. But population growth rates in some countries, and inadequate policy attention to human development concerns in most, have negated many of the gains made. The result is that there are now increasing absolute number of people in poverty, without adequate education, health and sanitation. Today, about 39 per cent of the adults in South Asia are illiterate, and about 4 out of every 10 of the primary-school children drop out before completing the primary cycle.[13]

In 2010 child and maternal mortality rates at 62 and 217 in 2010 were still very high.[14] Old diseases such as malaria and tuberculosis are staging a comeback.

There is a gender dimension to this picture. Defying the global biological norm, South Asia has only 94 women per 100 men (in 2010), showing the cradle to grave discrimination against girls and women.

The scale of human deprivation in South Asia is underscored by the sheer number of people in poverty. About 32 per cent (in 2010) of the population lives below the income required for meeting minimum daily needs. Using the definition of earning less than US$1.25 a day, South Asia has about half a billion poor people (495 million in 2010). Even according to national poverty line, which is different in each country, 29 per cent of South Asians are poor.[15]

Income inequality, as measured by Gini coefficient, has increased over the last three decades

Income inequality, as measured by Gini coefficient, has increased over the last three decades. The situation is even more disturbing in the case of inequality of opportunity in education, health, nutrition, jobs, etc. In education children in the richest income quintile are two times more likely to complete primary school.[16] Children in the lowest asset quintile are more likely to die before their fifth birthday. They are also more likely to be malnourished. South Asian governments are implementing social protection programmes to address the issues of income inequality.

Recent evidence suggests that the implementation of India's economic reform programmes has increased economic growth rate but has not made much progress in reducing poverty. The rate of poverty reduction in the 1980s was faster than in earlier period, due mainly to government policies to reach the poor in rural as well as urban areas through subsidised food and job-creation programmes. But in the 1990s, higher food prices and cutbacks of public-sector jobs played an important role in the slowing-down of poverty reduction, especially in rural areas.

Pakistan, on the other hand, has experienced both lower growth and higher incidence of poverty in the 1990s and 2000s. During the 1980s, when economic growth was higher poverty also showed a declining trend. But this has been reversed.

In Bangladesh too poverty has increased since 1995, compared to 1985, and the level of poverty is considerably higher in rural areas. In Sri Lanka, while poverty has declined at the national level, it increased in urban areas and decreased in rural areas. In Nepal, the proportion of poor people rose considerably during the 1990s.

Employment situation too has worsened. In this era of globalisation and market liberalisation, there has been a trend to move away from large enterprises, stable workforces and wage systems towards flexible production processes, and flexible employment and payments systems. Flexibility of employment has spread across the developing, transitional and industrialised countries. While national governments have created the space for various forms of flexibility by controlling labour unions, and introducing labour legislations and regulations to promote flexibility, firms have increased their control by relying largely on contracted employment. Global labour flexibility has become pervasive as it is advocated as a means to lower unemployment, raise economic growth, improve incomes and reduce inequality.

But in the context of South Asia, the flexibility of labour market has led to increased informalisation and casualisation of employment. In India, for example, the proportion of workforce formally covered by legal protection (minimum labour standards) is about 10 per cent, while informal sector activities accounted for about 84 per cent of employment.[17] More women are also joining the labour force, especially in the formal sector.

Thus, in critical areas such as improving the capability of the poor through better access to education and health and expanding their opportunities through improved access to jobs and real wages, the situation has worsened during the last decades in South Asia. While poverty has not declined, inequality has increased within each country. While the rate of illiteracy has declined, there is still a huge backlog of illiterate adults and out-of-school children. Also, malnutrition among the children continues to remain a daunting problem for most countries in the region.

Social development policies in South Asia

In the 1990s, all South Asian countries made commitments at the UN conferences in Jomtien (education), Cairo (population), Copenhagen (social development), and Beijing (women) to develop and implement policies and programmes for social development. The social sector policies at the central and provincial levels were developed in accordance with the global goals and national aspirations. Increased allocations were one of the imperatives to implement these goals. Yet, if we look at only two sectors—education and health—we see that public expenditure as a percentage of GDP has remained low in all countries. However, in the context of India and Pakistan, social sector expenditures are funded mostly out of state/provincial budgets, and thus are not fully reflected in the central budgets.

In 1980, public education expenditure was 1.6 per cent of South Asia's GDP, in 2000 it continued to remain low, at 3.1 per cent. In terms of the share of education in total public expenditure during 2010, it was 11.1 per cent. This proportion varied across the region with the highest in Nepal at 22.7 per cent and the lowest at 10.9 per cent, 10.5 per cent and 8.7 per cent in Pakistan, India and Sri Lanka respectively.[18]

In the era of globalisation, job and income insecurity are increasing

The social protection that a country provides for its citizens through a series of measures against the economic and social distress resulting from sickness and death of an income-earner, unemployment and old age, etc., is the backbone of the modern welfare state. In the era of globalisation, job and income insecurity are increasing, especially for women and other vulnerable groups who are dependent on informal and casual work where there is no provisions for special protection. In South Asia, where about 80 to 90 per cent of the labour force is in the informal sector, they are mostly outside the existing social protection schemes that cover only the formal sector.

Sri Lanka is the only South Asian country (excluding Bhutan and the Maldives) with a formal sector labour force of 37 per cent, so the social security programmes in Sri Lanka (such as pension, provident funds and life insurance schemes) cover the majority of the workforce.[19] But in Bangladesh, Pakistan and Nepal where majority of the workforce depends on the informal sector, social security systems cover less than 10 per cent of the population.[20] The poverty alleviation programmes, being implemented in each country, are designed to provide social assistance to the poor. But due to rising budgetary cuts, inefficiency and high costs of service delivery, even these programmes are not being effective in protecting the poor.

Thus, during the last decades when economic growth increased, social services expenditures stagnated. These expenditures were higher in Sri Lanka compared to other countries. Most South Asian countries were implementing the policies to reduce the size of government expenditure without restructuring the patterns of expenditure. Thus even in the 1990s, while on the one hand expenditures on social services were being reduced, overall public expenditure remained high due to high non-development expenditure.

Policy implications

The challenge for South Asia is not only to accelerate economic growth but also to improve the lives of the vast majority of its people

We must note at the outset that the South Asian policy makers, civil societies and the donor groups are already aware of the issues confronting the region and have been implementing some of the policy measures suggested below. But the region's problems are so overwhelming that the current efforts are not adequate enough to deliver economic growth with human development.

Today, the challenge for South Asia is not only to accelerate economic growth but also to improve the lives of the vast majority of its people. South Asia needs to make sustained efforts in four broad policy areas. These are: (a) accelerating human development, particularly education; (b) reducing poverty; (c) advancing gender equality; and (d) improving governance.

Accelerating human development

South Asia needs to improve both the quantity and quality of education at each level, from primary, secondary to tertiary. The first essential step is to achieve the goal of universal primary education. But this objective is yet to be achieved in Pakistan and Bhutan. Other countries though have achieved the enrolment goal have yet to address the issues related to learning achievement and completion of primary education.

South Asia needs to prepare its labour force to compete in the world market. Central to this is the strategy to provide quality primary and secondary education to all school-age children, provide them with relevant skills, and also cater to the needs of the higher levels of professional education. While the government should allocate sufficient resources for primary and secondary education, the private sector should be mobilised to set up institutions of higher learning. Education budgets of South Asia, as a percentage of both GDP and central and state/provincial government budgets, have to be increased in order to provide better access to quality education.

Similarly, improving healthcare is central to the debate on improving human development. Healthcare is perhaps the biggest challenge facing South Asia, with serious shortcomings in coverage and quality of provision, and considerable inequality between rural/urban, men/women, and poor/non-poor. These issues need to be prioritised to improve the living conditions, as well as productivity, of South Asia's labour force.

In South Asia, while there is a need for increasing expenditure on health, there is also a need for better allocation of expenditure to various sub-sectors. South Asia would benefit significantly by focusing on increasing access to primary healthcare and on preventive than curative care.

Addressing the shortcomings in education and healthcare systems would go a long way to enhance human development in the region.

Reducing poverty

Equitable patterns of growth are essential for sustainable poverty reduction. This requires a two-pronged approach consisting of broad-based economic growth and improved access to social services. Secondly, separate strategies are required for reducing poverty in rural and urban areas. Rural poverty requires more immediate attention as most South Asians live in rural areas. Elimination of urban bias in public expenditures and redirection of resources to rural development and agricultural support programmes are essential to address rural poverty.

Thirdly, since the region has accumulated much experience in poverty reduction programmes, it is important to learn from best practices. Experience shows that effective poverty reduction strategy requires the active involvement of local communities. The state of Kerala in India offers such an example where local ownership of poverty programmes made it possible to reduce poverty in that state.

Poverty reduction policies in South Asia must be mainstreamed. For macroeconomic policies, this means much more than just promoting economic growth. Poverty reduction strategies must be built into the macro and micro policies. Policies to encourage cash crops instead of food crops, and capital-intensive rather than labour-intensive industries need to be analysed to access their impact on the poor, rural areas, food security and employment generation.

One of the critical links between economic growth and human development is the expansion of employment opportunities. But in recent years many countries in South Asia have experienced periods of job-less growth. And even when jobs have been created, they often bypassed various groups of people on the basis of gender, class and ethnicity.

In South Asia, as about half (in 2010) of labour force is in agriculture, job-creating strategies should focus on rural areas and agro-industries so that the rural to urban migration is halted and rural economy revived.

Currently, the countries that are implementing the International Monetary Fund (IMF) and World Bank programmes have developed a holistic approach towards economic growth and poverty reduction. But it remains to be seen whether these efforts of the donors, and the government's response to these, are merely a half-hearted attempt to appease the opponents of globalisations or a real commitment to usher a human-centred development model.

Advancing gender equality

The human development model puts the concerns of all people, irrespective of gender, at the centre of policies, strategies and action. But in South Asia women are the most deprived people. In 2010, of the total number of illiterate people 64 per cent were women, and of the total number of out-of-school children 52 per cent were girls.[21] Women do not have legal equality with men in any South Asian country, despite constitutional guarantee in each country. As the majority of women work in the informal sector, their participation in, and their contribution to economic activity, are not recorded in the official statistics.

In the governance structures of South Asia, women have very little voice. Women occupied 13 per cent of parliamentary seats, 10 per cent of ministerial level positions, 7 per cent of the judiciary and 8 per cent of the civil services posts.[22] However, in the local governance structures, women are increasingly being inducted in all the countries.

One of the critical links between economic growth and human development is the expansion of employment opportunities

A truly engendered human development model in South Asia needs action in at least three critical areas:

1. Building women's capability. Although gender gaps in education and health have narrowed in recent years, the pace of progress has been inadequate and uneven within and among South Asian countries.
2. Improving opportunities for women. Without the opportunity to earn income and to participate in decision-making process, South Asian women will remain marginalised in economic and political spheres.
3. Equality of rights between women and men must not only be enshrined in the constitutions of South Asia, but must also be implemented and enforced in the true spirit of the law.

Improving governance

In the 1999 Report on *Human Development in South Asia*, South Asia emerged as one of the most poorly governed regions of the world, with corruption, inefficient economic management, centralised bureaucratic structures, and absence of rule of law dominating the political, economic and social landscape. Most taxes are regressive, their incidence fall more on the poor than on the rich. Poor economic governance has led to increasing poverty and human deprivation, increasing violence and reduced human security.

At the heart of any agenda for economic growth with human development must lie the affirmation of a broad-based democracy, based on rule of law, accountability and transparency

At the heart of any agenda for economic growth with human development must lie the affirmation of a broad-based democracy, based on rule of law, accountability and transparency. The real challenge is to create an environment where people are able and free to earn a living, to live in peace and security, to enjoy their human rights, and to participate, through their elected representatives, in the decisions that affect their lives. Transparency in all public actions, accountability of elected representatives, adherence to rule of law and devolution of power to lower levels of governance will provide just such an environment. A code of conduct for civil society and the private sector needs to be developed to complement government's efforts in promoting a humane governance that combines economic growth with social justice.

These are the issues that are analysed in depth in the following chapters in this Report.

CHAPTER 2

Economic Growth in South Asia, 1980-2010

South Asian countries, especially the two largest of India and Pakistan, achieved economic growth through liberalisation, globalisation and market reforms during 1980 to 2010. This rapid growth modernised their societies and lifted millions out of poverty, illiteracy and morbidity. Over these three decades, the region made a successful transition from an economy with a moderate rate of growth to one of the fastest growing regions in the world. Gross domestic product (GDP) growth in India, Pakistan, Bangladesh, Nepal and Sri Lanka grew more rapidly since the 1980s than in any other region except East Asia and the Pacific.[1] Yet this achievement in economic growth was not accompanied by comparable success in improving the living standards of all people in the region.

There is a two-way relationship between economic growth and human empowerment. With higher economic growth, governments are able to generate tax revenue allowing them to undertake expenditures to improve people's abilities and expand their earning opportunities. In this context, income growth is instrumental in increasing the range of choices and capabilities people enjoy, contributing to the human development of a nation. In turn, this improvement in education, health and nutrition increases productivity.

While the South Asian region has done well in terms of economic growth since the 1980s, this was also a period of growing deficits and rising foreign debt. While the service sector has been a key driver of economic growth, agriculture and industry have failed to create sufficient jobs or adequate food for the unemployed and the hungry. Fiscal policies were unable to generate adequate resources and monetary policies could not control inflation. While the total volume of trade increased, imports exceeded exports, resulting in a persistent trade deficit. The region experienced limited diversification, exporting primary products to a handful of markets. On a positive note, trade in services has generally been positive, with exports exceeding imports, especially in India. Growth has been unevenly distributed between the agricultural and non-agricultural sectors, creating a considerable rural-urban divide. Similarly, economic growth has been uneven across provinces, regions and states. These disparities in economic growth make the growth process exclusive and inequality-enhancing.

In this chapter, the experiences of five South Asian countries—India, Pakistan, Bangladesh, Nepal and Sri Lanka—are presented to evaluate their growth during the three decades under investigation (1980-2010). After a regional assessment of their growth record in this section, a brief discussion of each country's performance will follow in the next section.

Over the three decades, the region made a successful transition from an economy with a moderate rate of growth to one of the fastest growing regions in the world

Section 1: Economic growth in South Asia

GDP growth during 1980 to 2010

South Asia's economic performance has been encouraging over the past three decades. Driven by economic reforms and liberalisation policies, the economic outlook of South Asia has transformed significantly. The region stands as one of the principal drivers of the global economy. South Asia as a whole has performed better than other developing region (figure 2.1), with an average growth rate of 5.9 per cent per annum, second only to East Asia and the Pacific.

Figure 2.1 GDP annual growth of different developing regions of the world, 1980-2010

Source: World Bank 2015g and MHHDC staff computations.

Within South Asia, India's economic growth has been the most impressive. In fact, the economic rise of South Asia is largely attributed to India. Being the largest economy in the region, India drives the economic performance of South Asia. Sri Lanka and Bangladesh have closely followed India, as their economies have also grown at a sustained rate during this period. Pakistan and Nepal, however, are exceptions to South Asia's success, as GDP growth in both countries has remained volatile. Political instability in Pakistan during the 1990s and in Nepal, between 2000 and 2010, could be responsible for this.

There is now strong evidence that economic progress in South Asia is largely attributed to structural reforms that the national governments undertook in the last three decades. These reforms included the liberalisation of trade and industrial policies and the privatisation of the financial sector. As a result, South Asia experienced robust growth in exports and increased inflow of foreign direct investments (FDI) and remittances, increasing the pace of economic growth. India has been at the forefront of these reforms, when it opened up its economy in 1990 to international trade and investment and deregulated the private sector. The private sector facilitated India's economic revival over the past three decades.

Composition of GDP

The composition of the economy is an important factor in determining whether the benefits of growth are reaching the poorer segments of society. For growth to be pro-poor, it should favour sectors where the poor are concentrated, and utilise the skills that they possess. This would generate employment for the less privileged.

In South Asia prior to the 1980s, the Green Revolution resulted in high growth in the agricultural sector, making it the leading contributor to the economy. This growth was pro-poor as a majority of the poor are concentrated in rural areas and depend on agriculture for their livelihood. However, since then, major structural change has taken place in South Asian economies. The share of agriculture in the economy has plummeted sharply, while the service sector has now become the dominant sector in all South Asian countries. Growth has been concentrated in this sector, and its contribution to GDP has gone up from 41.3 per cent to 54.7 per cent during the past three decades. The contribution of agriculture has declined from 34.8 per cent to 19.2 per cent, whereas that of industry has marginally risen by 2.2 percentage points.[2]

Within South Asia, India has shown impressive growth in the service sector, while Bangladesh has witnessed phenomenal growth in manufacturing. Improved management of economic policy led to this impressive growth in Bangladesh. The share of agriculture in GDP has fallen most rapidly in Nepal and in India, while it has decreased the least in Pakistan.[3] It is argued that increased international trade and withdrawal of agriculture subsidies in some countries, such as India, have been a major contributor to the declining share of agriculture. Increased international trade has also exposed small farmers to intense international competition and greater price volatility.

The pattern of economic growth in South Asia has mostly benefitted the urban middle class as they are better equipped to take advantage of employment opportunities generated by the service sector. Growth in the service sector has raised non-farm incomes in both rural and urban areas.

Savings and investment

One of the major reasons for increased economic growth in South Asia has been the liberalisation of the financial sector since the 1980s. Prior to this, the financial system was under state control, with governments allocating credit to favoured sectors. Interest rates were artificially managed at low levels, and banking regulations were complex. The government determined who got access to credit and at what rate. Financial sector reforms, largely led by India and followed by other countries, resulted in market-determined interest rates, a reduction in reserve and liquidity requirements and legalisation of foreign currency deposits. As a result, access to credit of domestic borrowers increased, more capital was available and investments by both nationals and foreigners rose.

Within South Asia, the reform process adopted by India was slightly different than the other South Asian countries, especially Pakistan. In India, the role of the state was evolved as a regulator to ensure prudent reforms. The state maintained strategic control to build and strengthen financial institutions, improve banking infrastructure and develop policies to mobilise savings for productive investment. As a result, financial infrastructure deepened in India and it accumulated substantial financial reserves to maintain monetary stability. In contrast, Pakistan often faced balance of payment crises, leading to increased reliance on foreign aid and International Monetary Fund (IMF) assistance.

In general, these reforms led to an increase in the total volume of savings and investment across the region. Gross domestic savings as a percentage of GDP increased in India, Bangladesh, Sri Lanka and Nepal. In Pakistan however, national savings fluctuated. The increased trend in saving rates across the region is due to increased remittances and greater saving opportunities provided by an expanding financial sector.

The region has witnessed a significant increase in investment since the 1980s. This is especially true for India, Bangladesh and Nepal. In Pakistan, investment rates dipped during 1996-2000 and 2005-10. In Sri Lanka, conflicts and violence have negatively affected investment flows. The general growth in investment rates across South Asia is due to a rapid rise in the private sector. This changed the composition of gross investment in the region, as the share of public investment in total investment declined and the share of private investment increased. Financial sector liberalisation and deregulation of the economy were the main factors responsible for this change.

Government revenue and expenditure

Although South Asian governments successfully took the first steps to promote economic growth, economic security—particularly of the poor—is still elusive. In this regard, effective management of the fiscal sector is important. Fiscal policy, especially that dealing with public expenditure and taxation, is the best instrument for sharing the benefits of growth with the poor. However, in South Asia over the past three decades, no major change was observed in fiscal indicators. Even in the best performing economies like India, economic resources were mismanaged, resulting in persistent fiscal deficit. Despite high economic growth in India and in other South Asian countries, sufficient revenues were not mobilised to meet growing government expenditures. In general, total revenues—particularly tax revenues— either stagnated or decreased. South Asian governments were unable to re-orient the structure of public spending in favour of social services, as defence and interest payments dominated, as compared to education and health. Another common trend within South Asian countries was the declining share of capital expenditure

Although South Asian governments successfully took the first steps to promote economic growth, economic security—particularly of the poor—is still elusive

Economic outlook transformed significantly when most of the countries adopted a more outward-oriented development strategy, emphasising greater integration with the world economy

in comparison to revenue expenditure, reflecting reduced spending on infrastructure development. Persistent fiscal deficits increased the debt burden of South Asian economies.

Government revenue as a percentage of GDP has not increased substantially over the past three decades in any of the South Asian countries. In fact, in all countries, the tax-to-GDP ratio was lower than the developing country average.[4] The only increase was witnessed in Bangladesh and Nepal, while the larger countries have struggled to increase government revenues. It has decreased not only in Pakistan, but also in India, where total revenue as a percentage of GDP has stagnated. This is despite the fact that all South Asian countries undertook major tax reforms during this period. A narrow tax base, inefficient tax administration and structural factors such as the presence of a large informal economy, are amongst the reasons for a low tax-to-GDP ratio in South Asia. In the two largest economies of the region, India and Pakistan, large-scale exemptions in the agricultural sector negate any effort to broaden the tax net. However, tax reforms have led to a more progressive tax structure, with an increasing share of direct taxes in comparison to indirect taxes. This is especially true of India and Nepal.

Over the past three decades, public expenditure in South Asia did not increase at a pace sufficient to meet pressing infrastructural and development needs. While government expenditure was relatively high during the 1980s and the 1990s, it declined in subsequent years. Capital expenditure declined in all economies, while the share of revenue expenditure increased. Defence and interest payments dominated government expenditure in place of spending on social sectors like education and health.

Persistent fiscal deficit was the natural outcome of stagnating revenues and fluctuating outlays. The budget deficit was particularly high in the 1980s and the 1990s, but has since then declined in all economies. Declining trends in budget deficit were due to economic reforms that reduced both the role of the government in the economy as well as spending on development. In many South Asian countries, especially Pakistan, these reforms were introduced as part of an IMF-led Structural Adjustment Programme. In addition, India and Pakistan introduced legislations to ensure prudent fiscal management, namely the Fiscal Responsibility and Budget Management (FRBM) Act 2003 in India, and the Fiscal Responsibility and Debt Limitation Act 2005 in Pakistan. Both were successful in reducing fiscal deficits.

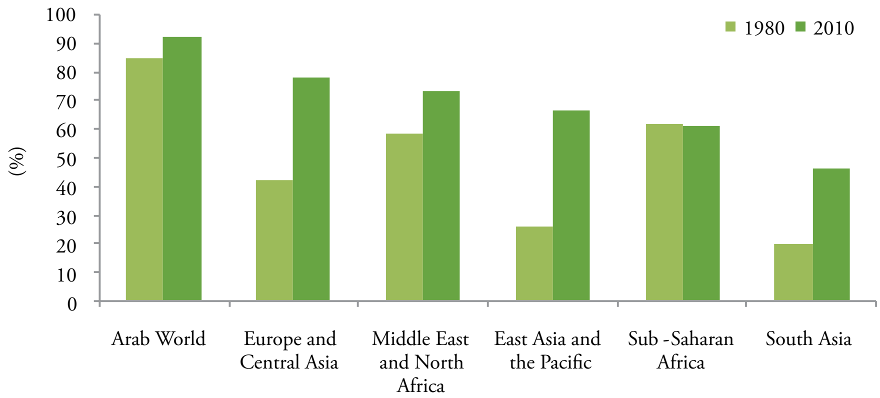
Despite these reforms, public debt remained significantly high in all countries, both in nominal terms and as a percentage of GDP. Debt management became extremely difficult in Pakistan and Sri Lanka. While there has been some decline in public debt in recent years, it is still a major financial problem hindering the social and economic progress of South Asian countries.

Trade

During the period under investigation, international trade reached unprecedented heights and more countries were integrating into global economic networks. South Asia was an important part of this wave towards globalisation. Its trade-to-GDP ratio, an indicator of trade openness, significantly increased since the 1980s (figure 2.2). During this time, the region's trade-to-GDP ratio more than doubled, increasing from 19.3 per cent in 1980 to 45.9 per cent in 2010. However, despite this rapid increase, South Asia remains the least integrated region in the world.

Prior to the 1980s, the region was classified as growing at a sluggish pace, with poor growth prospects. But its economic outlook transformed significantly when most of the countries adopted a more outward-oriented development strategy, emphasising greater integration with the world economy. Major policy reforms included reductions in quantitative restrictions and tariffs, improvement in export incentives, betterment in business climate for foreign investors, and devaluation of

Figure 2.2 Trade-to- GDP ratio of different regions of the world, 1980-2010*



Note: *: Data for Europe and Central Asia is for 1990 and for East Asia and the Pacific is for 1982 instead of 1980. Similarly, data for Middle East and North Africa is for 2007 instead of 2010.
Source: World Bank 2015g.

exchange rates. As a result, the trade-to-GDP ratio of these countries started rising rapidly. Indeed, Sri Lanka, India and Nepal had very high trade-to-GDP ratios.[5]

While the basic elements were the same, both the impetus for, and the actual process of reforms varied among the different countries. Sri Lanka and Bangladesh were at the forefront of this process during the late 1970s, while Pakistan and India were laggards, beginning in the 1990s. In Pakistan, a substantial move towards liberalisation was negotiated under the auspices of the IMF and the World Bank that led to stabilisation and the implementation of the Structural Adjustment Programme. In India, the balance of payment crisis led to the realisation of the need to enhance trade. In Pakistan, the implementation of tariff reforms was slow because of the fear of loss in revenues; in India, they were strategic. Import of capital goods was substantially liberalised, especially those that promised future exports, while that of consumer goods was more cautious. Bangladesh also tried to simplify and rationalise the tariff structure while simultaneously setting up export processing zones to boost exports.

To reap the benefits from increased trade and to maintain a positive trade balance, it is essential to improve the performance of exports. However in South Asia, while both imports and exports increased, the increase in imports outpaced the increase in exports. This has resulted in recurring trade deficits in all the countries. In fact, trade deficits increased overtime, especially between 2000 and 2010. The negative balance of trade constrained the meager financial resources of these economies, resulting in the accumulation of debt.

Trade expansion can only take an economy so far. The benefits of increased trade are also dependent on how the structure of trade changed in response to new opportunities in the global trading system. Over the past three decades, South Asian merchandise exports mirrored the global trend of rising shares of manufactured goods and falling shares of primary commodities. Despite this improvement, the share of manufactured goods in merchandise exports is lower than the levels achieved by East Asia and the Pacific as well as Europe and Central Asia.[6] Within South Asia, Bangladesh has the highest share of manufactured goods in its export basket, while the share of the same has also increased rapidly in Sri Lanka and Nepal.[7] Bangladesh's success is mainly because of expansion in the ready-made garments (RMG) industry. The majority of regional exports, however, are concentrated in manufactured goods of agriculture origin, such as textile and clothing. This leaves the region vulnerable to not only fluctuations in international cotton prices, but also to production failures—on account of drought, disease and pests. Only in India does there exist a degree of export diversification that is comparable to the high-export countries of East Asia.

South Asian countries also have narrow export markets that are largely concentrated in Europe and the US. Moreover, a very low proportion of total trade is with Asian countries. Only India has managed to create new export destinations, in Asia and Africa.

Most of the region's imports are from within Asia, especially China and oil-exporting Middle-Eastern countries. Regional trade within South Asia is very low, and again, India has been the only country to expand its export market to include Nepal, Sri Lanka and Bangladesh.

One positive development in regional trade is increased trade in services. This is especially true for India and Nepal. India has been a global leader in the export of services and has a positive trade balance. Meanwhile, Nepal has made significant headway in travel and tourism.

The benefit of trade liberalisation can only be evaluated in terms of its effect on poverty, inequality and human development. Smart policies aimed at increasing and diversifying exports, especially in labour-intensive sectors of the economy, are one way to ensure gains from trade for people.

Economic growth of states/provinces

The rapid economic growth that South Asia witnessed over the past three decades has not been equally distributed within each country. Significant variation exists in the GDP share of several state/provincial/administrative divisions in each country. In India, states like Maharashtra, Tamil Nadu, Uttar Pradesh, Andhra Pradesh, Gujarat, West Bengal and Karnataka have performed exceptionally well, unlike the north eastern states. Similarly in Pakistan, Punjab dominated Sindh, Khyber Pakhtunkhwa (KPK) and Balochistan in terms of share in national GDP. In Bangladesh, out of the six administrative divisions, Dhaka, Chittagong and Rajshahi contributed the most to national GDP as compared to Sylhet, Barisal and Khulna. In Sri Lanka, the Western Province was the most developed, in contrast to the war-affected Northern and Eastern provinces.

While it is impossible to ensure complete equity in the distribution of growth, some parity should be maintained when determining regional, provincial or state allocations for social services. Human capabilities can most certainly be augmented by diverting more national resources to lagging areas to safeguard the long-run economic interests of these regions.

The next section assesses the growth performance of the five countries in more detail.

Section 2: Country profiles[8]

India

Trends in economic growth

India's economic growth performance, when evaluated in a historical context, has a very positive outlook. Although India's economic growth was not encouraging during the first three decades after its independence, since the 1980s economic growth in India has been rising steadily (table 2.1). In recent years, economic growth has slowed down mainly because of trends in the global economy.

The acceleration of the Indian economy during the 1980s may be attributed to the dismantling of state controls, a predominant feature of pre-reform economic policy-making. The key features of these reforms included import liberalisa-

Table 2.1 Trends in GDP and GDP growth rate (2004 as base year) in India, 1980-2014

	Real GDP (INR trillions)	GDP per capita (INR)	GDP growth rate (%)
1980-90	11.0	14,767	5.7
1990-2000	18.8	20,485	5.8
2000-10	35.1	32,051	6.9
2010-14	57.5	47,563	6.7

Source: GOI 2015b and MHHDC staff computations.

tion—especially of capital goods and intermediate inputs—export incentives through taxes, easy access to credit and foreign exchange, relaxation of industrial licensing requirements, and reduced state control on prices. The decade of the 1990s witnessed further progress in the form of abolition of industrial licensing and allowance of FDI. In addition, reforms were deepened through the elimination of import licences and reduction in non-tariff barriers, opening up of the financial sector, and easing of investment regulations in important services such as telecommunication. These reforms of the 1980s and 1990s led to a sharp increase in the growth of the Indian economy.

Economic growth in India continued into the early 2000s. Indeed, the Indian economy witnessed unprecedented GDP growth of 8.8 per cent between 2004 and 2008.[9] This phase of growth was mainly credited to large capital inflows and coincided with a high growth phase of the global economy. However, the growth process suffered a setback with the onset of the global financial crisis in 2008, and the growth rate declined from 9.8 per cent in 2008 to 3.9 per cent in 2009.[10] This slowdown in global growth and demand had an adverse impact on local markets, given the high degree of openness of the Indian economy. Large capital outflows during this period also had negative repercussions for the economy, as they were the key determinants of economic growth prior to the financial crisis. Growth rebounded initially during 2010 and 2011, mainly in response to a large monetary and fiscal stimulus provided by the government. Subsequently however, the economy has cooled down significantly, due to a worsening of India's fiscal and current account deficits.

Despite troubles in the later half of the 2000s, on the whole, the Indian economy did extremely well over the past three decades. In absolute terms, India's GDP increased from around INR11.0 trillion during the 1980s to INR57.5 trillion between 2010 and 2014. A high GDP growth rate coupled with a marginal drop in population growth rate resulted in a three-fold increase in per capita GDP during the past three decades—from INR15 thousand to INR48 thousand (see table 2.1).

Over the span of three decades, the Indian economy has evolved from being a closed economy with high trade barriers to one that is more open to international trade and investment. More critically, it has transformed from being a regulated economy with stringent bureaucratic controls curbing private economic activity to an increasingly liberalised one amenable to private sector growth. The outcomes are reflected in the remarkable trajectory of growth, from a rate as low as 3.4 per cent during 1950-1980 to a respectable 6.1 per cent over the next three decades.[11]

Sectoral growth

The structure of the Indian economy has changed significantly over the years, from being an agro-based economy to one that is more dominated by services. As indicated in table 2.2, the share of agriculture in GDP declined by almost 60 per cent between 1981 and 2011. The share of services increased from about 45.3 per cent of GDP in 1981 to 65.1 per cent in 2011. Industry showed only a marginal increase of 2.2 percentage points during the three decades between 1981 and 2011. The surge in contribution of the service sector to GDP and the corresponding decline in the share of agriculture is due to higher average annual growth rates of the former since 1981, and the lowest growth in agriculture (see table 2.2).

Within agriculture, crop cultivation is still the largest contributor in terms

Table 2.2 Composition of GDP by major sectors, 1981-2011

	Share in GDP (%)				Average annual growth rate (%)		
	1981	1991	2001	2011	1981-91	1991-2001	2001-11
Agriculture	35.7	29.6	22.2	14.6	3.5	2.8	3.3
Industry	18.1	20.6	20.6	20.3	6.8	5.8	7.5
Services	45.3	49.6	56.9	65.1	6.4	7.2	9.2

Source: GOI 2015b and MHHDC staff computations.

of volume. However its share in national GDP has declined since the 1980s from 29.8 per cent in 1981 to 12.4 per cent in 2011. The growth of this sector has varied because of its high dependence on climatic conditions. Similarly, the share of allied activities in national GDP has declined, but the contribution of the fishery and livestock sectors has increased since the 1980s.[12] Growth in these sectors is important, as Indian farmers supplement their agricultural income with earnings from livestock and fishery. Moreover, this sector promotes a relatively more equitable income distribution as livestock ownership is skewed in favour of small farmers and women.

The industrial sector in India underwent significant change since the economic reforms of the 1990s. The share of mining and quarrying declined, while that of the manufacturing sector increased. Within manufacturing, it was the capital goods sector that led growth during the 1980s. However growth cooled down following the reforms of the 1990s, particularly in the aftermath of tariff reductions for capital goods and import expansion. Since then, industrial growth has been evenly distributed across consumer, capital and intermediate goods.[13]

Table 2.3 Sectoral composition of GDP, 1981-2011

(% of GDP)

	1981	1991	2001	2011
Agriculture	35.7	29.5	22.3	14.6
Crop	29.8	24.9	18.7	12.4
Allied activities (livestock, forestry and fishing)	5.9	4.6	3.6	2.2
Industry	18.0	20.6	20.6	20.3
Mining and quarrying	2.6	3.5	3.0	2.3
Manufacturing	14.0	15.1	15.5	16.1
Services	45.3	49.6	56.9	65.1
Construction	7.6	7.1	6.6	7.6
Trade, hotel, transport and communications	16.8	17.6	21.6	27.3
Finance, insurance, real estate and business services	8.2	11.5	14.0	17.3
Community, social and personal services	12.7	13.4	14.7	12.9

Source: GOI 2015b and MHHDC staff computations.

Table 2.4 Trends in savings in India, 1981-2011

(% of GDP)

	Gross domestic savings	Household savings	Private corporate savings	Public sector savings
1981	17.8	12.1	1.6	4.1
1991	22.9	18.5	2.6	1.8
2001	23.7	21.3	3.7	-1.3
2011	34.0	23.5	7.9	2.6

Source: GOI 2015b and MHHDC staff computations.

As table 2.3 indicates, within services, the sub-sector of trade, hotel, transport and communications has contributed the most to GDP. In fact, the contribution of this sector to the overall service sector has remained steady since the 1980s. Communications has been the fastest growing component within the service sector in the post-liberalisation phase. This is followed by banking and insurance, due to the rise of private players in the financial market during the reform period.

Analysing the growth process in India from a human perspective reveals a mixed picture. While the growth of the service sector has raised per capita GDP, its contribution towards poverty reduction is limited. Compared to agriculture and industry, the service sector is less labour-intensive and requires skilled labour. In contrast, the growth of agriculture and manufacturing expands employment opportunities, especially for the poor. Unfortunately, the growth of these two sectors has not been substantial over the last three decades.

Savings and investment

Increased economic growth in India has largely been attributed to rising saving and investment rates—a major policy focus since the 1980s. As a result, the volume and composition of domestic savings in India has undergone significant changes over time. Gross domestic savings as a percentage of GDP gradually increased from 17.8 per cent in 1981 to 34.0 per cent in 2011 (table 2.4). While India's gross domestic savings have steadily increased over time, the composition changed significantly. Public sector savings as a proportion of GDP declined by 36.6 per cent over this time, and was even negative during 1999 and 2003. However, after the enactment of the FRBM Act of 2003, there was a slight improvement. In contrast, private savings, both household and corporate, succeeded in offsetting this decline. Household savings as a fraction of GDP increased from 12.1 per cent to 23.5 per cent between 1981 and 2011. They declined slightly in the period of 2001-07, mainly due to a tight monetary policy that lowered interest rates to reduce inflation. Private sector savings, which were stagnant till the late 1980s, witnessed a tremendous (five-fold) increase during the last three decades.[14]

Similar changes of volume and composition occurred in investment. Investment as a percentage of GDP rose steadily, from a very low level of 10.7 per cent in 1981 to 39.1 per cent in 2008.[15] Prior to financial liberalisation, total investment was dominated by the public sector. Beginning in the 1990s this composition changed as a consequence of liberalisation, with the private sector driving overall investment levels. The share of public investment in the total declined by 54 per cent from 1980 to 2008. On the other hand, the share of private corporate investment increased by a 100 per cent over the same time.[16]

Improvement in saving and investment rates was an outcome of financial sector reforms that were initiated in the early 1980s and strengthened by the 1990s. Prior to the 1980s, India had an interventionist approach to monetary policy, with strong government control on banking and capital flows. However, in the 1990s, capital accounts were freed and foreign direct and private investment grew. Total investment inflows from abroad increased from US$103 million in 1990 to US$41.6 billion in 2011,[17] with soaring direct and portfolio investment. Foreign investment has aided the absorption of capital and technology in India, substantially promoting economic growth. However, despite a significant increase in the volume of foreign investment inflows, India is still below par compared to China, Russia and Brazil.[18]

While savings and investment have improved because of financial sector reforms, these reforms slowed down the expansion in bank branches, reduced credit access in rural and semi-urban areas, and limited outreach for agriculture as well as small-scale industries. During the nationalisation phase prior to the reforms, there was emphasis on expanding the geographical network of bank branches to ensure better access to institutional credit. However as table 2.5 indicates, this focus has reversed since the 1990s, with the percentage of branches in rural versus urban areas declining. This trend holds for credit disbursements as well (table 2.6).

To mitigate these biases, the Government of India has undertaken special policy initiatives, such as expanding the budget of the Rural Infrastructure Development Fund and increasing funding for the National Bank for Agriculture and Rural Development. This is in addition to increasing the number of Regional Rural Banks and providing credit through microfinance, the Self-help Group Bank Linkage programme and the *Kisan* Credit Card Scheme.

Government revenue and expenditure

Fiscal policy is a major instrument through which the government can ensure that

Table 2.5 Spread of branch network in India, 1991-2011

	Rural		Semi-urban		Total*
	Number of branches (thousands)	Share of total (%)	Number of branches (thousands)	Share of total (%)	Number of branches (thousands)
1991	35	58.5	11	18.8	60
2001	33	49.4	15	22.1	66
2011	32	38.0	21	24.3	86

Note: *: Total includes rural, semi-urban and urban branches.
Source: GOI 2015b and MHHDC staff computations.

Table 2.6 Spread of credit disbursement in India, 1981-2011

(%)

	Rural	Semi-urban	Urban	Metropolitan
1981	9.6	16.4	22.3	51.7
1991	21.5	16.7	22.0	39.8
2001	12.8	13.2	17.7	56.3
2011	11.5	11.0	17.7	59.7

Source: GOI 2015b and MHHDC staff computations.

economic growth promotes social development. While India's economy has grown substantially over the past three decades, fiscal policy in terms of total revenue, public expenditure and fiscal deficit has remained the same. Total revenue has averaged around 9.3 per cent of GDP during the three decades, and with average total expenditure at 15.7 per cent, fiscal deficit has persisted in the Indian economy (table 2.7).

Fiscal deficit in India stood at 5.7 per cent over the last three decades. It was extremely high in the 1980s, peaking at 7.6 per cent in 1991. It fell to an average of around 5.0 per cent in the 1990s due to economic reforms that lowered the level of government activity. Significant improvement also took place after the launch of the FRBM Act in 2003,[19] as the deficit decreased to 4.0 per cent in 2006. The Act forced the central government to take measures to reduce the fiscal deficit to around 3.0 per cent by 2009, with an annual deficit reduction target of 0.3 per cent of GDP per annum. Fiscal deficit increased in subsequent years largely due to the monetary and fiscal stimulus given by the government to rescue the economy in the wake of the global financial crisis.

In line with the falling fiscal deficit, total expenditure of the central government shrank by 3.5 percentage points in the post-reforms years between 1991 and 1996. Public expenditure also decreased substantially after the FRBM Act 2003, only to rise again by 2011. While the Act has been successful in curtailing both the budget deficit and government expenditure, the composition of public expenditure is a matter of concern. Capital expenditure as a proportion of GDP decreased substantially by 64.3 per cent over the last three decades. In contrast, the revenue expenditure of the government increased from 9.6 per cent of GDP in 1981 to 13.4 per cent in 2011. A large proportion of total government expenditure—around 15 per cent—is still spent on defence, and the share of interest payments increased from 11.4 per cent in 1981 to 19.5 per cent in 2011 (table 2.8). In 2001, interest payments reached a high of around 30.5 per cent of total expenditure. In contrast, social sector expenditure was low, averaging around 5.3 per cent over the past three decades.

On the revenue side, total revenue has not increased substantially, only increasing from 8 per cent of GDP in 1981 to around 10 per cent in 2011.[20] While earnings from the agricultural sector are largely exempted from income tax, the service sector has recently been included in the tax network as part of efforts to widen the tax base. The composition of the tax structure has improved, as the share of direct taxes in total tax revenue has increased in comparison to non-tax revenue (see table 2.9).

Overall, the budget deficit has led to increased borrowing by the government, both from internal and external sources. Table 2.10 shows that total debt increased between 1981 and 2011, from INR0.6 tril-

Table 2.7 Trends in public finance in India, 1981-2011

(% of GDP)

	1981	1986	1991	1996	2001	2006	2011
Total revenue	8.3	9.7	9.4	9.0	8.9	9.4	10.1
.Tax	6.3	7.3	7.3	6.7	6.3	7.3	7.3
Total expenditure	15.2	18.2	18.0	14.5	15.0	13.7	15.4
.Revenue	9.6	11.7	12.5	11.4	12.8	11.9	13.4
.Capital	5.6	6.5	5.4	3.1	2.2	1.8	2.0
Budget deficit	-5.6	-7.6	-7.6	-4.9	-5.5	-4.0	-4.8
Public debt	41.4	52.4	59.6	57.3	59.6	63.9	52.2
.Domestic	32.4	41.2	48.3	45.2	50.8	58.6	48.6
.Foreign	9.0	11.2	11.3	12.1	8.8	5.3	3.6

Source: GOI 2015b and MHHDC staff computations.

Table 2.8 Trends in expenditure in India, 1981-2011

	Revenue expenditure	Capital expenditure	Defence	Interest	Subsidies	Social sector expenditure
	(% of GDP)		(% of total expenditure)			
1981	9.6	5.6	15.8	11.4	8.9	4.3
1986	11.7	6.5	15.2	14.3	9.1	2.8
1991	12.5	5.4	14.6	20.4	11.5	3.0
1996	11.4	3.1	15.1	28.1	7.1	4.2
2001	12.8	2.2	15.2	30.5	8.2	5.2
2006	11.9	1.8	15.9	26.2	9.4	7.4
2011	13.4	2.0	12.9	19.5	14.5	10.3

Source: GOI 2015b and MHHDC staff computations.

lion to INR40.6 trillion, rising from 41.4 per cent of GDP to 52.2 per cent. Total debt climbed to 63.9 per cent of GDP in 2006, but has since then declined to present levels. The composition of debt has also undergone some changes over the last three decades, with external debt as a percentage of GDP falling from 9.0 per cent to 3.6 per cent. This is compensated by the increase in domestic borrowing, which grew by 50 per cent (as a share of GDP) from 1981 to 2011.

Trade

Trade liberalisation was a major component of the economic reform process in India. In addition to incentives for attracting international investment, the key features of these reforms included exchange rate devaluation along with a market-based exchange rate and a parallel reduction in tariff and non-tariff barriers. Further trade liberalisation occurred with the abolition of quotas for imports and exports in keeping with World Trade Organization's regulations.

Under these reforms, India transitioned from being an inward- to an outward-oriented economy. The total volume of international trade grew 26 times, from US$24 billion in 1981 to US$ 621 billion in 2011.[21] The downside of increased international trade was a massive trade deficit. While there was a significant increase in both, the increase in imports outweighed that of exports. The trade deficit increased from US$7 billion in 1981 to US$119 billion in 2011. This imposed significant constraints on the financial resources of the government and led to an accumulation of international debt.

The structure of India's exports changed significantly over the past three decades. In 1981, exports of agriculture and allied products accounted for 30.7 per cent of total exports but by 2011, this decreased to 9.7 per cent.[22] Exports of ores and minerals increased significantly, while that of manufactured goods also increased slightly over the past three decades. Despite this transition, India's exports are still concentrated in a few products. India however has successfully diversified its exports markets from being concentrated in Europe and America, to Asia and Africa.[23]

Table 2.9 Trends in tax structure in India, 1981-2011

(% of total taxes)

	Direct taxes	Indirect taxes
1981	20.2	79.8
1991	16.1	83.9
2001	36.3	63.7
2011	55.0	45.0

Source: GOI 2015b and MHHDC staff computations.

Table 2.10 Trends in debt structure in India, 1981-2011

	Internal debt	External debt	Internal debt	External debt	Total debt
	(INR trillions)		(% of GDP)		
1981	0.5	0.1	32.4	9.0	41.4
1986	1.2	0.3	41.2	11.2	52.4
1991	2.8	0.7	48.3	11.3	59.6
1996	5.5	1.5	45.2	12.1	57.3
2001	11.0	1.9	50.8	8.8	59.6
2006	21.7	1.9	58.6	5.3	63.9
2011	37.8	2.8	48.6	3.6	52.2

Source: GOI 2015b and MHHDC staff computations.

A major proportion of India's imports are raw materials and intermediate manufactured goods, comprising 62.4 per cent of total imports. In comparison, the share of capital goods and food is small. Within raw materials, petroleum products account for the highest share (28.7 per cent) of total imports, highlighting India's growing energy needs. However, heavy imports of intermediate goods harm small-scale producers, who are the principal producers of such goods in India.[24]

One positive aspect of India's international trade is the growing trade in services. While both imports and exports of services have increased over time, India has been recording a surplus in services trade since 2000. In 2011, the balance of trade in services was US$48.8 billion, with exports of US$132.9 billion and imports accounting for US$84.1 billion.[25] Indeed, the surplus in India's services exports has been able to finance a large part of India's overall trade deficit.

Economic growth by state

India's economic transformation over the past three decades serves as a lesson not only for South Asia, but also for other developing countries of the world. While aggregate economic growth in India has been phenomenal, it masks huge inequalities, especially across various states of the country. The wide disparity in economic performance across states threatens the sustainability of India's growth performance. What is worse is that these imbalances are mirrored and reinforced in socio-economic outcomes, a reflection of the inability of the government to help states that have been sidelined from the growth process.

Substantial variations in the average annual growth rate during 2001-09, ranging from an impressive 10.6 per cent in Gujarat, to a sluggish 4.5 per cent in Madhya Pradesh, make this trend evident. It is also apparent that the gap between states has widened over the past three decades. During this time, Gujarat, Haryana and Kerala have performed exceptionally well. In fact, Gujarat and Kerala have transformed themselves from ranking amongst the bottom states of India in the 1980s, to being at the top by 2010. In contrast, Madhya Pradesh, Assam and Uttar Pradesh have been stuck at the lower end of the economic spectrum (see table 2.11).

Disparity in economic growth has translated into gross inequities in living standards, as measured by per capita incomes across Indian states. As may be inferred from table 2.11, the average resident of Uttar Pradesh is 3.5 times poorer than that of Haryana. Evidence suggests that Haryana, Gujarat and Kerala have relatively higher per capita incomes as compared to the low performing states of Madhya Pradesh, Assam and Uttar Pradesh.

Similarly, although Human Developement Index (HDI) showed a significant overall improvement in the last three decades, there have been wide differences among states. States that have done well on the economic front have also experienced human development, with Kerala ranking first in India. Assam, Uttar Pradesh and Madhya Pradesh have persistently had the lowest HDI values amongst all states. While the interplay of politics, governance and the economic structures of these states are to be blamed for their poor performance, the central government remains equally negligent in distributing growth.

Table 2.11 Selected indicators for high and low performing Indian states

	Net state domestic product (NSDP) growth rates (%)		Per capita NSDP (INR thousands)	Proportion (%) of population multi-dimensionally poor	Human Development Index (HDI) value	
	1980-90	2000-09	2011	2006	1991	2006
High performance						
Gujarat	4.8	10.6	77	41.0	0.431	0.634
Haryana	6.3	9.5	94	39.3	0.443	0.643
Kerala	2.6	8.5	68	12.7	0.591	0.764
Low performance						
Assam	3.3	5.3	33	60.1	0.348	0.595
Madhya Pradesh	3.6	4.5	32	68.1	0.328	0.529
Uttar Pradesh	4.8	5.4	27	68.1	0.314	0.528
India	5.7	6.9	45	53.7	0.381	0.605

Sources: Nayak *et al.* 2010, GOI 2014b and Dreze and Sen 2013.

Pakistan

The economy of Pakistan grew at an annual rate of 5.1 per cent since the 1980s. Agriculture, industry and services collectively contributed to economic growth. However, services and the industrial sector outperformed agriculture. Pakistan's economy also did reasonably well because of positive trends in savings, consumption, investment and trade. A provincial level analysis of economic growth reveals an encouraging picture of the economy over the last three decades.

Trends in economic growth

Between 1980 and 2010, the economy of Pakistan progressed at an annual rate of 5.1 per cent (see table 2.12) despite being marred by conflicts, political turmoil, and natural calamities. In absolute terms, Pakistan's real GDP increased by more than four times during this duration, from PKR2 trillion to PKR8.9 trillion. Real per capita GDP also doubled, from PKR25 thousand to PKR51 thousand, while the population more than doubled, from 81.4 million to 173.5 million.

This economic growth was due to a strong rural farm sector, increasing foreign remittances, natural resources, and a substantial informal sector. In 2014, Pakistani diaspora sent US$15.8 billion to Pakistan, an increase of 14 per cent compared to the US$13.9 billion received in 2013. The agricultural sector accounted for one-fifth of GDP, about half of employment and three-fifths of exports. According to estimates by the Pakistan Institute of Development Economics (PIDE), the illegal informal economy was about 90 per cent of the formal economy, almost double the size of actual and per capita GDP.[26]

In the 1980s, GDP increased at an annual rate of 6.3 per cent. This was mainly due to the successful implementation of the 6th Five Year Plan (1983-88). The Plan involved major tax reforms, deregulation of the economy, and increased emphasis on education, health and poverty alleviation.

However, during the 1990s, the growth rates of GDP and per capita GDP declined. During this period, GDP increased at 4.5 per cent per annum, but showed a slight improvement in the 2000s, rising to 4.6 per cent.

In recent years, there have been indications of a growth recovery in GDP and per capita GDP. The government has taken a number of steps to address terrorism and energy issues in pursuit of high economic growth. These include a military operation against terrorists, initiatives to address the ongoing energy crisis, efforts to restore investor's confidence, and a renewed commitment towards regional cooperation. The government has also formulated the Vision 2025 and a Five Year Plan to improve and sustain economic growth. However, these efforts have yet to bear fruit.

Table 2.12 Trends in economic growth (2006 as base year) in Pakistan, 1980-2010

	Growth rate (%)		
	GDP	Population	Per capita GDP
1980-90	6.3	3.1	3.1
1990-2000	4.5	2.4	2.0
2000-2010	4.6	2.2	2.3
1980-2010	5.1	2.6	2.5

Sources: GOP 2005a, GOP, *Economic Survey of Pakistan* (various issues) and MHHDC staff computations.

Sectoral growth

A sector-wise analysis of Pakistan's GDP over the last three decades shows two trends. First, the growth rate of all the sub-sectors remained positive. As table 2.13 shows, between 1981 and 2010, the growth rate of the service sector increased at an annual rate of 6.7 per cent, the agricultural sector increased by 5.1 per cent, while manufacturing increased by 4.3 per cent. The growth rate of the industrial sector has slowed down since the 1990s onwards, showing the inability of the sector to compete in the global market and to absorb the surplus labour from the farm sector.

Secondly, the share of agriculture and industry decreased, while that of services increased significantly. Between 1980 and 2010, the share of agriculture and industry in GDP decreased by 7.6 and 3.8 percentage points respectively, while the share of the service sector increased by 11.3 percentage points. This indicates a structural shift in the economy (see table 2.14).

Within the agricultural sector,

Table 2.13 Growth rate of economy by sectors, 1981-2010

	1981-90	1991-2000	2001-2010	1981-2010
Agriculture	5.4	4.4	3.2	5.1
Manufacturing	8.2	4.8	7.1	4.3
Services	6.7	4.6	5.1	6.7
GDP	6.4	4.5	4.8	5.1

Sources: GOP 2005a, GOP, *Economic Survey of Pakistan* (various issues) and MHHDC staff computations.

the focus has moved from crops to livestock. Similarly, the share of forestry has decreased significantly, while the share of fishing has improved marginally. In the industrial sector, large scale manufacturing is the largest sub-sector, and its share increased from 46 per cent of value added in the industrial sector to 54 per cent between 1980 and 2010. However, in terms of value addition, the share of small scale manufacturing decreased by 61.3 per cent in the industrial sector between 1980 and 2010, which had negative implications for employment creation. In the service sector, the sub-sectors of wholesale and retail trade as well as transport, storage and communications have the largest shares and have performed impressively over the last three decades (see table 2.14).The share of these two sub-sectors in the total value added by the service sector increased from 51 per cent to 57 per cent between 1980 and 2010.

Table 2.14 Sectoral shares of GDP in Pakistan, 1980-2010

(%)

	1980	1990	2000	2010
Agriculture	29.6	26.0	25.9	22.0
Crops	20.9	15.1	13.1	9.1
Livestock	7.9	9.8	11.7	11.9
Fishing	0.5	0.8	0.4	0.5
Forestry	0.2	0.3	0.7	0.6
Industry	24.8	25.2	23.3	21.0
Manufacturing	15.8	17.4	14.7	13.6
Large scale	11.5	12.3	9.5	11.3
Small scale	4.3	5.1	3.7	1.4
Services	45.6	48.8	50.7	56.9
Wholesale and retail trade	16.0	17.0	17.5	19.1
Transport, storage and communications	7.4	8.0	11.3	13.3
Finance and insurance	2.5	2.0	3.7	3.3

Sources: GOP 2005a and 2014c.

Table 2.15 Trends in savings and investment in Pakistan, 1981-2010

(% of GDP)

	1981-85	1986-90	1991-95	1996-2000	2001-05	2010
Gross investment	18.7	18.8	19.5	17.5	17.4	15.8
.Public	9.3	9.0	8.6	6.4	4.5	3.7
.Private	7.5	8.1	9.4	9.3	11.4	10.5
Gross domestic savings	7.9	10.8	14.6	14.3	17.0	9.8
Gross national savings	14.9	14.8	15.0	13.1	18.3	13.6

Sources: GOP 2005a and 2014c and MHHDC staff computations.

Savings and investment

High rates of savings and investment over the past three decades contributed towards economic growth in Pakistan. Savings were used for infrastructure development, social sector expenditure and creation of employment opportunities.

Investment as a percentage of GDP increased slightly between the first half of the 1980s and the 1990s, reaching 19.5 per cent (see table 2.15). It fluctuated after that, peaking at 19.3 per cent in 2006 and decreasing to 15.8 per cent in 2010. An important feature of investment in Pakistan was that public investment decreased considerably, whereas private investment increased. Specifically, public investment as a percentage of GDP declined significantly by 60.2 per cent between the first half of the 1980s and 2010. Meanwhile, private investment as a percentage of GDP increased over this time from 7.5 per cent to 10.5 per cent. Sector-wise analysis shows the highest investment was in services, followed by agriculture and industry.

A similar trend was witnessed in savings. National savings as a percentage of GDP grew from a low level of 14.9 per cent to 18.3 per cent between the 1980s and the 2000s mainly due to an increase in foreign remittances, but by 2010 decreased substantially to 13.6 per cent. This fall in the later years was due to rising consumption. Savings declined across all income groups in urban areas, while they increased marginally in rural areas between 2002 and 2012.[27]

Government revenue and expenditure

Pakistan's fiscal indicators—especially government revenue and budget deficit—improved during the 1980s and 1990s, but have deteriorated since then. The tax-to-GDP ratio slightly increased between 1980 and 1996, from 3.6 per cent to 14.4 per cent. However, it decreased to 10 per cent in the 2000s, mainly due to a decrease in taxes on international trade. Recently, the ratio has recovered somewhat due to a number of government initiatives (see table 2.16).

The fiscal deficit improved significantly, as shown in table 2.16, from about 7.0 per cent of GDP in the 1980s and 1990s to 4.4 per cent in the 2000s, mainly due to the stabilisation measures adopted under the IMF programme.[28] However, it again worsened by the end of the 2000s, as the government exited the IMF programme. A similar trend has been observed recently after the adoption of the IMF programme by the new government.

The share of current expenditure in the total expenditures increased from 60 per cent to 80 per cent between 1980 and 2010, while development expenditure decreased by 100 per cent, settling at 20 per cent in 2010. Current expenditure includes debt servicing, defence, subsidies, cost of civil administration, etc. In 2013, debt servicing accounted for 33 per cent of current expenditure,[29] followed by defence expenditure at 14.8 per cent. In contrast, pensions accounted for only 4.7 per cent of spending.[30]

The share of domestic debt in total debt increased from 39 per cent in 1980 to 46 per cent in 2010, while that of external debt and liabilities decreased from 61 per cent to 51 per cent. This has crowded out private investment and created inflationary pressures.

Trade

Trade is an important driver of economic growth. Over the past three decades, Pakistan's economy integrated into global financial and capital markets and resultantly, between 1980 and 2010, merchandise trade increased more than seven times from US$7.1 billion to US$54.0 billion. During this period, exports increased from US$2.4 billion to US$19.3 billion, while imports increased from US$4.7 billion to US$34.7 billion, at an annual rate of 7.2 per cent and 6.9 per cent respectively. Table 2.17 shows that the growth rate of exports was higher than imports during the 1980s and the 1990s; however the trend reversed in the 2000s.

Table 2.16 Trends in public finance (consolidated federal and provincial governments) in Pakistan, 1980-2010

(% of GDP)

	1980	1990	2000	2010
Total revenue	16.4	18.6	13.4	14.0
.Tax	13.9	14.0	10.6	9.9
Total expenditures	23.3	25.9	18.5	20.2
.Current	14.0	19.3	16.4	16.0
.Development	9.3	6.5	2.5	4.1
Budget deficit	-6.3	-6.5	-5.4	-6.2
Total debt	55.6	91.7	88.0	68.0
.Domestic	21.5	42.8	41.6	31.4
.External	34.0	48.9	46.4	34.9

Sources: GOP 2004, 2007b, 2012a and *Economic Survey of Pakistan* (various issues).

Table 2.17 Trends in exports and imports in Pakistan, 1980-2010

Value (US$ billions)			Annual compound growth rate (%)		
	Exports	Imports		Exports	Imports
1980	2.4	4.7	1980-90	7.7	3.9
1990	5.0	6.9	1990-2000	5.6	4.0
2000	8.6	10.3	2000-10	8.5	12.9
2010	19.3	34.7	1980-2010	7.2	6.9

Sources: GOP 2005a and 2013a.

Interestingly, exports as a percentage of GDP increased from 9.8 per cent in the 1980s to 12.3 per cent in the 2000s, while the same measure for imports decreased from 18.7 per cent to 16.2 per cent.[31]

Like other countries in the region, Pakistan's trade is concentrated in a few products to limited destinations. Textile, rice and leather are the main exports of Pakistan, accounting for 72.4 per cent of total exports. Half of the country's exports are destined for the US, China, the UAE, Afghanistan, the UK and Germany. In the case of imports, petroleum products, machinery, raw materials and food items make up about 70 per cent of total imports. Roughly 60 per cent of total imports are sourced from the UAE, China, Kuwait, Saudi Arabia, Malaysia and Japan.

Economic growth by province

Economic growth in Pakistan is not equally distributed. Although Balochistan is the largest province in terms of total area of

Pakistan (44 per cent), as figure 2.3 shows, it is the smallest province in terms of its share in the country's GDP (8 per cent). Punjab is the largest province of Pakistan with respect to its contribution to GDP (55 per cent).

Between 1973 and 2005, while national GDP increased at an annual rate of 5.1 per cent, the trend varied within Pakistan. GDP increased by 5.2 per cent in Punjab, 4.9 per cent in Sindh and KPK, and 4.2 per cent in Balochistan (table 2.18). The low level of GDP growth in Balochistan is attributed to relatively poor and underdeveloped economic and social sectors. However in recent years some improvement in economic activity has taken place in Balochistan.

Bangladesh

Trends in economic growth

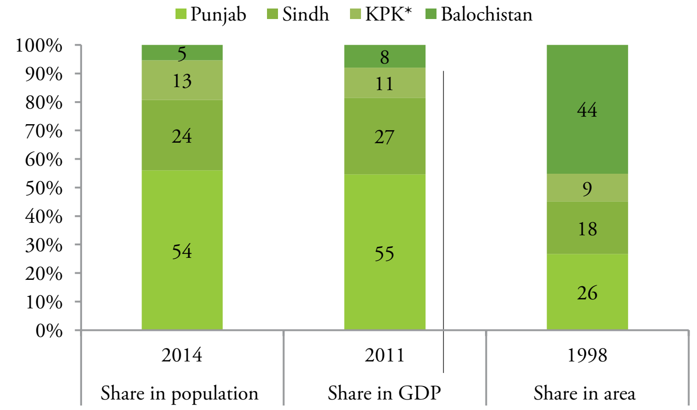
Bangladesh has made good progress over the last three decades. Growth occurred at a sustained rate of 4.8 per cent (see table 2.19). A decade-wise analysis shows that GDP growth rose from 3.7 per cent in the 1980s to 4.8 per cent in the 1990s. It further grew to 5.8 per cent in the 2000s. This growth may be attributed to macroeconomic stability, deregulation of the economy, trade openness, and financial sector development. As a result of this continuous increase in GDP and a concurrent gradual decrease in population growth, per capita GDP also improved at a higher and sustained rate during this period.

Over the last four years, the growth rate of Bangladesh's economy has been about 6.2 per cent. This shows the remarkable resilience of the economy in the face of global financial turmoil, dwindling remittances due to political unrest in the Middle East and natural disasters. Specifically, this is ascribed to the buoyancy of its exports, investment growth, as well as a strong domestic capacity to deal with natural disasters.

In absolute terms, Bangladesh's real GDP increased by four times, from BTK0.9 trillion in 1980 to BTK3.6 trillion in 2010, while real per capita GDP increased by 2.5 times, from BTK10 thousand to BTK25 thousand.[32]

One important feature of economic growth in Bangladesh is a decrease in its volatility, due to a number of structural changes in the economy. The agricultural sector has adjusted well to natural disasters with the spread of dry-season irrigated crop production and a higher contribution of the non-crop sector to GDP. The contribution of industry and services to GDP and

Figure 2.3 Share in population, area and GDP in Pakistan by province



Note: *: KPK means Khyber Pakhtunkhwa
Sources: GOP 2014c and Ikram 2009.

Table 2.18 Trends in per capita and overall GDP in Pakistan by province

	GDP growth rate (%)		Per capita GDP	
	1973-2005 (at 1973 prices)	2006-11 (at 2000 prices)	Growth rate, 1981-2005 at (1981 prices)	US$ (2004)
Punjab	5.2	3.9	2.8	580
Sindh	4.9	3.1	2.3	760
KPK	4.9	2.8	2.3	480
Balochistan	4.2	4.2	2.1	410
Pakistan	5.0	3.6	2.6	600

Sources: World Bank 2013a and Ikram 2009.

Table 2.19 Trends in economic growth (1996 as base year) in Bangladesh, 1980-2010

	Average annual growth rate (%)		
	GDP	Population	Per capita GDP
1980-90	3.7	2.1	1.6
1990-2000	4.8	1.7	3.1
2000-2010	5.8	1.3	4.4
1980-2010	4.8	1.7	3.0

Sources: GOB 2011 and 2014a and MHHDC staff computations.

employment has soared. The development of infrastructure and domestic markets has increased the country's capacity to absorb external shocks. The government has also developed an effective disaster management system.

Sectoral growth

In 1979, the economy of Bangladesh was mainly agrarian. However, over the last three decades, the contribution of the agricultural sector to GDP has decreased in light of the predominance of the industrial and service sectors (see table 2.20). Between 1979 and 2010, the share of agriculture in GDP decreased by 24.6 percentage points, while that of the industrial and the service sectors increased by 11.7 and 12.9 percentage points respectively.

Interestingly, even though the share of the agricultural sector in GDP fell sharply, its growth rate gradually improved between 1980 and 2010. All the sub-sectors of agriculture, including crops, livestock, forestry and fisheries, registered steady growth during this time (see table 2.21).[33] Crops is the leading sector, accounting for 60 per cent of the agricultural value added. In value terms, rice accounts for 60 per cent of crops. Despite the dominance of rice, structural change has occurred. In terms of value added in the agricultural sector, the share of crops fell from 65 per cent in 1980-90 to 56 per cent in 2010, while the contribution of livestock remained stagnant at 13 per cent. However, both fisheries and forestry have gained.

The contribution to GDP of industry increased to 30 per cent in 2010, of which manufacturing was 18 per cent. During the 1980s, the outlook of the manufacturing sector was bleak due to the presence of nationalised enterprises, inward-looking trade policies and inadequate private investment. However, the sector performed impressively throughout the 1990s and the 2000s due to deregulation, trade liberalisation, better exchange rate management, and improved financial sector performance. The manufacturing sector dominated export earnings (see table 2.22).[34] Within the service sector, as detailed in table 2.23, the sub-sectors of wholesale and retail trade (28.9 per cent) as well as transport, storage and communications (21.7 per cent) were the main drivers of growth.

Table 2.20 Sectoral shares of GDP in Bangladesh, 1979-2010

(% of GDP)

	1979	1989	1999	2010
Agriculture	44.9	37.1	25.3	20.3
Industry	18.2	17.1	25.7	29.9
Services	36.9	45.8	49.0	49.8

Sources: GOB 2014a and MHHDC 2012.

Table 2.21 Shares of agricultural sub-sectors in GDP (at 1996 prices), 1980-2010

(% of GDP)

	1980-90	1991-2000	2000-09	2010
Agriculture (A+B)	31.2	26.7	22.7	20.3
A. Agriculture and forestry	26.5	21.4	17.6	15.8
i) Crops and horticulture	20.2	16.1	12.9	11.4
ii) Animal farming	4.0	3.4	3.0	2.7
iii) Forests and related services	2.2	2.0	1.9	1.7
B. Fishing	4.8	5.3	5.1	4.5

Sources: GOB 2011 and 2014a.

Table 2.22 Shares of manufacturing sub-sectors in GDP, 1981-2010

	1981	1991	2001	2010
Share (% of GDP)				
Manufacturing	13.4	13.0	15.1	17.9
i) Large and medium scale	9.4	9.1	10.8	12.7
ii) Small scale	4.0	3.9	4.3	5.3
Growth (% change)				
Manufacturing	4.4	6.4	6.7	6.5
i) Large and medium scale	4.2	6.0	6.6	6.0
ii) Small scale	4.8	7.3	7.0	7.8
Share (% of exports of goods)				
Manufacturing share	65.5	78.9	92.1	5.6
Ready-made garments sector share	0.1	38.9	56.1	77.1

Sources: GOB 2011 and 2014a.

Table 2.23 Shares of services sub-sectors in GDP, 1981-2010

	1981	1991	2001	2010
Overall services	47.4	47.9	50.0	49.8
Wholesale and retail trade	12.5	12.1	12.8	14.4
Transport, storage and communications	10.4	9.4	8.7	10.8
Real estate, renting and business activities	8.0	8.4	8.8	7.2
Community, social and personal services	7.9	8.8	8.5	6.8

Sources: GOB 2011 and 2014a.

Savings and investment

The private sector of Bangladesh was the major contributor to economic growth. The ratio of investment-to-GDP stagnated to around 16-17 per cent in the 1980s. However, it gradually increased from about 20 per cent in the 1990s to 24 per cent in 2010. This increase was due to dynamism in private sector investment, which increased from about 11 per cent of GDP in the 1980s to around 19 per cent in 2010 (see table 2.24). Investment in the public sector however decreased somewhat, from 5.5 per cent of GDP to 5.0 per cent between the 1980s and 2010. This has resulted in inadequate public infrastructure and stagnating productivity.

National savings, comprising domestic savings and foreign remittances, rose from about 11 per cent in the 1980s to 30 per cent in 2010. The domestic saving rate as a percentage of GDP increased due to supportive demographic transition, the expansion of savings opportunities, and an increase in corporate savings attributed to an improved business environment. The impressive growth of remittances also served to augment the national savings rate.[34]

Table 2.24 Trends in savings and investment in Bangladesh, 1981-2010

(% of GDP)

	1981-85	1986 -90	1991-95	1996-2000	2001-05	2010
Gross investment	16.4	16.6	17.9	21.5	23.6	24.4
.Public	4.8	6.1	6.7	6.8	6.4	5.0
.Private	12.1	10.4	11.3	14.7	17.2	19.4
Gross domestic savings	8.0	9.4	12.5	15.3	16.9	20.1
Gross national savings	10.7	12.3	15.5	18.9	23.0	30.0

Sources: GOB 2014a and Mahmud *et al.* 2008.

Table 2.25 Trends in public finances in Bangladesh, 1980-2010

(% of GDP)

	1980	1990	2000	2010
Total revenue	6.0	6.7	8.5	10.9
.Tax	5.2	5.7	6.8	9.0
Total expenditures	11.9	13.4	14.5	14.6
.Current	4.5	6.7	7.8	11.0
.Annual development plan	7.4	5.7	6.5	3.7
Budget deficit	-9.4	-9.2	-6.1	-3.7
Public debt	27.6	43.1	46.6	46.7
.Domestic	8.8	8.3	12.2	16.6
.External	18.8	34.8	34.4	30.1

Sources: GOB 2011 and 2014a

Government revenue and expenditure

In Bangladesh, the tax-to-GDP ratio gradually climbed from 5.2 per cent in 1980 to 9.0 per cent in 2010 (table 2.25). However, it is still very low compared to other developing countries. This is due to a complex tax structure, low tax compliance, administrative weakness, untaxed agricultural sector, tax exemptions and tax holidays.

The fiscal deficit gradually dropped from 9.4 per cent in 1980 to 3.7 per cent in 2010. A cut in development expenditure led to a fall in fiscal deficit. While the share of revenue expenditure in total expenditure grew by 97.3 per cent between 1980 and 2010, that of development expenditure decreased from 62 per cent to 28 per cent during this period. A low ratio of tax-to-GDP in the presence of fiscal deficit resulted in an increase in public debt, with a high incidence of domestic debt.

Trade

Merchandise exports and remittances have been the basis of sustained GDP growth in Bangladesh over the last three decades. Exports of goods increased from US$0.7 billion in 1981 to US$16.2 billion in 2010, while imports increased from US$2.3 billion to US$23.7 billion during this time. On average, exports increased at a higher rate than imports during the last three decades: exports growth was at an annual rate of 11.4 per cent, and imports at 8.4 per cent (see table 2.26).

A similar trend was observed in terms of the share of exports and imports in GDP. Between 1981 and 2010, exports increased from 5.0 per cent of GDP to 16.2 per cent. Imports also increased from 16.0 per cent of GDP to 21.3 per cent during this period.[36]

In term of export destinations, about 60 per cent of total goods are exported to Germany, the UK, France and the Netherlands.[37] The most important sector in exports is the RMG sector. It employs four million people, of which 80 per cent are women. Since the start of trade liberalisation, the role of the RMG sector has increased significantly. Its share in total exports increased from an insubstantial 0.1 per cent in 1981 to a sizeable 77.1 per cent in 2010 (table 2.22).

The country's imports consist of petroleum-related products, wheat, textiles, raw cotton, edible oil, sugar, capital machinery, plastics, rubber and fertilizer. The main import partners are China, India, Singapore, Malaysia, Japan and South Korea, accounting for about half of the total imports of Bangladesh.[38]

Table 2.26 Trends in trade in Bangladesh, 1981-2010

	Value (US$ billions)		Annual compound growth rate (%)		
	Exports	Imports	Year	Exports	Imports
1981	0.7	2.3	1981-90	8.9	5.7
1990	1.5	3.8	1990-2000	14.2	8.3
2000	5.8	8.4	2000-10	10.9	11.0
2010	16.2	23.7	1981-2010	11.4	8.4

Sources: GOB 2005a and 2012b, Malik 2011 and MHHDC staff computations.

Table 2.27 Trends in per capita and overall GDP in Bangladesh by administrative division, 1983-2000

	Per capita GDP (BTK thousands)	Share in total GDP (%)	Per capita GDP	growth (%)
	2000	2000	1983-89	1990-99
Dhaka	22	37.7	1.3	3.3
Chittagong	18	19.3	1.7	3.0
Khulna	18	11.6	2.6	3.0
Barisal	15	5.8	2.1	2.2
Sylhet	15	5.2	0.0	3.1
Rajshahi	15	20.4	6.6	2.6
Overall	19	100.0	1.6	2.9

Sources: GOB 2011and World Bank 2007

Economic growth by administrative division

In terms of contribution to national GDP, as table 2.27 reveals, Dhaka (37.7 per cent) has the highest share, followed by Rajshahi (20.4 per cent), Chittagong (19.3 per cent), Khulna (11.6 per cent), Barisal (5.8 per cent) and Sylhet (5.2 per cent).

Per capita income is the highest in Dhaka (BTK22 thousand), making it the most well-off division, and the poorest is Sylhet (BTK15 thousand). Overall, Dhaka, Chittagong and Khulna are the most developed divisions of Bangladesh, while Sylhet, Rajshahi and Barisal are the least developed (table 2.27).

An analysis of the growth rate of per capita GDP shows a mixed trend among the six administrative divisions of Bangladesh—Dhaka, Chittagong, Khulna, Barisal, Sylhet and Rajshahi. Between 1983-89 and 1990-99, the growth rate of per capita GDP increased by 3.1 percentage points in Sylhet, followed by 2.0 and 1.3 percentage points in Dhaka and Chittagong respectively.

Nepal

Trends in economic growth

Nepal's economic growth performance over the past three decades was volatile. The economy performed well in the 1980s and the 1990s, with GDP growth of around 5.0 per cent. Political turmoil in the 2000s drastically impacted Nepal's economy and the growth rate declined to 2.9 per cent in 2011. Political stability in recent years led to economic recovery; however Nepal's economic growth is still lower than many low-income countries.

In absolute terms, both GDP and GDP per capita increased since the 1980s. Nepal's GDP increased from NPR0.18 trillion in 1981 to NPR0.59 trillion in 2011 (table 2.28). In per capita terms over the same period, it rose by 83.3 per cent. Despite these positive trends, the growth rate of per capita GDP has been falling

Table 2.28 Trends in GDP and GDP per capita (2001 as base year) in Nepal, 1981-2011

	GDP (NPR trillions)	GDP per capita (NPR thousands)	GDP growth rate (%)
1981	0.18	12	…
1991	0.28	15	4.9
2001	0.44	19	5.0
2011	0.59	22	2.9

Sources: GON 2011b and 2014a and MHHDC staff computations.

since the 1980s: from 2.8 per cent in the 1980s, it has dropped to 1.5 per cent during 2000-10.[39]

Sectoral growth

The structure of Nepal's economy has transformed over the past three decades. The non-agricultural sector has replaced the agricultural sector as the principal source of economic activity. Table 2.29 reveals that even though agriculture accounted for 60 per cent of the country's GDP in 1981, its share decreased to 35 per cent in 2011. In contrast, the share of non-agriculture activities increased from 40 per cent of GDP in 1981 to 65 per cent in 2011 (table 2.29).

Table 2.29 Composition of GDP by major sectors, 1981-2011

	Share in GDP (%)				Average annual growth rate (%)		
	1981	1991	2001	2011	1981-90	1991-2000	2001-10
Agriculture	59.9	47.5	36.6	35.0	3.2	2.4	3.4
Non-agriculture	40.1	52.5	63.4	65.0	7.4	7.0	4.0

Source: GON 2014a and MHHDC staff computations.

Table 2.30 Sectoral composition of GDP, 1981-2011

	2001	2011
Agriculture	36.6	35.0
Crop and forestry	36.2	34.6
Allied activities (livestock, fishing)	0.4	0.4
Industry	9.5	6.9
Mining and quarrying	0.4	0.5
Manufacturing	9.0	6.4
Services	54.0	58.1
Construction	6.0	6.5
Trade, hotel, transport and communications	25.8	23.6
Finance, insurance, real estate and business services	11.0	12.5
Community, social and personal services	11.2	15.5

Source: GON 2013d and MHHDC staff computations.

Table 2.31 Trends in savings and investment in Nepal, 1981-2011

	Total investment		Gross domestic savings		Gross national savings		Resource gap
	NPR billions	% of GDP	NPR billions	% of GDP	NPR billions	% of GDP	% of GDP
1981	4.8	17.6	3.0	10.9	4.5	16.5	-1.1
1991	25.1	20.8	11.5	9.6	13.9	11.5	-9.3
2001	98.7	22.3	51.5	11.7	118.8	26.9	4.6
2011	519.3	38.0	190.9	14.0	506.3	37.0	-0.9

Source: GON 2014a and MHHDC staff computations.

Within agriculture, the sub-sector of crops dominated, while allied activities accounted for a marginal share of 0.4 per cent of GDP (table 2.30). However output from the crop sector is heavily dependent on climatic conditions.

In the non-agricultural sector, the contribution of industry is low. In 2001, industrial output accounted for around 9.5 per cent of GDP, and by 2011, its share had declined to 6.9 per cent. The service sector has become important in the overall economy. Within services, the sub-sector of trade, hotel, transport and communications has become critical, adding around 23.6 per cent to the overall GDP. In recent years, other service sub-sectors including social services, finance and construction have performed better overall. Constraints in energy, transportation and communications and associated costs have adversely impacted the overall economy.

Savings and investment

In Nepal, savings and investment as a proportion of GDP have increased. Total investment as a percentage of GDP rose from 17.6 per cent in 1981 to 38.0 per cent in 2011. Similarly total national savings as a fraction of GDP also surged from 16.5 per cent in 1981 to 37.0 per cent in 2011 (table 2.31). As a result, the resource gap between savings and investment has largely balanced out. In absolute terms, total investment increased from NPR4.8 billion in 1981 to NPR519 billion in 2011. Similarly, national savings soared from a low NPR4.5 billion in 1981 to NPR506 billion in 2011.

Despite this progress, Nepal is facing issues in mobilising even greater savings and allocating resources to productive sectors for the promotion of industry and trade. Additionally, it needs to prevent capital flight to India and capitalise on increased remittances to increase savings and hence investment. To achieve the primary objective of encouraging domestic savings and diverting bank resources to preferred sectors, Nepal adopted two sets of interest rate policies. Firstly, real interest rates were regulated and kept positive to incentivise savings and to maintain interest rate competitiveness with India to curb capital flight. Secondly, since 1981, Nepal also introduced a differential interest rate policy in an incentive lending programme to guide credit flows to preferred sectors of the economy. While it achieved mixed results, in the wake of liberalisation, Nepal is gradually deregulating interest rates of both bank and non-bank financial institution, while simultaneously phasing out the incentive lending programme. This will not only create competition in the financial sector, but also push banks and financial institutions to mobilise financial resources and allocate them optimally.

Government revenue and expenditure

Nepal's economy has remained in deficit over the past three decades. Table 2.32 shows that the budget deficit grew substantially during the 1980s, from 2.9 per cent of GDP in 1981 to 8.9 per cent of GDP in 1991. Since then, it fell to 5.5 per cent in 2001 and to 3.6 per cent of GDP in 2011.

The budget deficit of the 1980s was largely explained by rising expenditure in the face of stagnant revenues. Total expenditure averaged around 18.3 per cent, increasing from 15.0 per cent of GDP in 1981 to 19.6 per cent in 1991. In contrast, total revenue averaged around 8.8 per cent of GDP, resulting in a burgeoning budget deficit. The situation in Nepal started improving in the 1990s, as public expenditure fell to an average of 18 per cent of GDP in the 1990s and revenues touched 9.2 per cent of GDP. During 2000-10, there was further improvement as this trend continued: revenue increased significantly, compensating for a slight increase in government expenditure (see table 2.32). The 1980s witnessed a significant increase in government expenditure, especially capital expenditure. It paved the way for accelerated development on a sustainable basis and in reducing infrastructural bottlenecks in the economy. However, since 1991, revenue expenditure largely replaced capital expenditure as a percentage of GDP (table 2.32).

Government revenue in Nepal increased mainly because of an increase in taxes. Tax revenue jumped from 7.5 per cent of GDP in 1981 to 13.0 per cent in 2011 (table 2.32), while in absolute terms total taxes increased from NPR0.7 billion in 1981 to NPR72.3 billion in 2011 (table 2.33). Tax composition improved in favour of the poor as the proportion of indirect taxes in total taxes decreased from 52.5 per cent in 1981 to 32.7 per cent in 2011.

In terms of allocation, economic expenditure increased in the 1980s, whereas the social sector was prioritised during the 1990s and 2000s (see table 2.34). Expenditure on interest payments in Nepal has remained within manageable limits during the past three decades.

The fiscal deficit in Nepal is financed by borrowing. Total debt in Nepal grew by a factor of more than a hundred, from around NPR4 billion in 1981 to NPR438.9 billion in 2011 (table 2.35).

Table 2.32 Trends in public finance in Nepal, 1981-2011

(% of GDP)

	1981	1991	2001	2001
Total revenue	8.9	8.9	11.1	14.6
.Tax	7.5	6.8	8.8	13.0
Total expenditure	15.0	19.6	18.1	21.6
.Revenue	4.7	5.7	10.4	15.4
.Capital	10.0	13.3	6.4	3.5
Budget deficit	-2.9	-8.9	-5.5	-3.6
Debt financing				
.Domestic	0.9	3.8	1.6	3.1
.Foreign	2.5	5.2	2.7	0.9

Source: GON 2014a and MHHDC staff computations.

Table 2.33 Trends in tax structure in Nepal, 1981-2011

	Direct taxes		Indirect taxes	
	NPR billions	% of total tax	NPR billions	% of total tax
1981	0.3	47.5	0.4	52.5
1991	1.3	33.5	2.6	66.5
2001	9.8	49.3	10.0	50.7
2011	48.6	67.3	23.7	32.7

Source: GON 2014a and MHHDC staff computations.

Table 2.34 Trends in public expenditure by function in Nepal, 1981-2011 (% of GDP)			
	Economic expenditure	Social expenditure	Interest payments
1981	8.1	2.9	0.8
1991	10.2	3.6	2.0
2001	5.2	5.4	2.4
2011	4.6	8.5	2.2

Source: GON 2014a and MHHDC staff computtions.

Table 2.35 Trends in debt structure in Nepal, 1981-2011					
	Debt (NPR billions)			Debt (% of GDP)	
	Domestic	Foreign	Total	Domestic	Foreign
1981	1.4	2.5	4.0	5.3	9.0
1991	20.9	59.5	80.4	17.3	49.4
2001	60.0	201.6	261.6	13.6	45.6
2011	179.3	259.6	438.9	13.1	19.0

Source: GON 2014a and MHHDC staff computations.

In terms of composition, foreign debt has been higher than domestic debt throughout the last three decades. Foreign debt surged to very high levels during the 1990s and early 2000s, remaining above 40 per cent of GDP during 1991 and 2004. However since then, it gradually decreased to manageable levels of around 19 per cent of GDP in 2011.

Trade

Nepal adopted trade liberalisation policies during the mid-1980s. It signed several bilateral, regional and multilateral trading agreements like the South Asia Free Trade Agreement (SAFTA) and the Bay of Bengal Initiative for Multi-sectoral Trade and Economic Cooperation (BIMSTEC). While these efforts have enhanced trade volumes, it has largely resulted in rising imports and volatile exports, widening the trade deficit.

The volume of trade increased from US$0.59 billion in 1980 to US$7.35 billion in 2010, especially between 2000 and 2010, when Nepal formally entered regional trading agreements through SAFTA and BIMSTEC. Between 1980 and 2010, exports rose from US$0.22 billion to US$1.53 billion, while imports also grew substantially from US$0.36 billion to US$5.82 billion. As a percentage of GDP, imports increased gradually from 18.7 per cent in 1980 to 36.4 per cent in 2010. In contrast, export performance has been unstable, with exports (as a percentage of GDP) ranging from 11.5 per cent in 1980 to 9.6 per cent in 2010. There was a massive surge in exports as a percentage of GDP in between, when, in 2000, they reached 23.3 per cent. Nepal's trade deficit expanded between 1980 and 2010, from 7.2 to 26.8 per cent of GDP (table 2.36).

Some of the major constraints facing Nepal include limited market access, a narrow export base and poor industrial capacity. Being land-locked makes trade diversification harder for Nepal, and India remains its most important trade destination, accounting for around two-thirds of Nepal's total trade. This trend is mirrored in India's share of exports out of total exports (67.4 per cent) and its share in Nepal's total imports (66.1 per cent).[40] However, Nepal is at a disadvantage in its trading relations with India, due to both India's protective trade regime and higher competitiveness stemming from firm-level economies of scale. Trade is also restricted because of higher transaction costs and time delays involved in transporting goods through India.

Nepal's export earnings are vulnerable on account of largely being based on primary and agricultural products that have volatile prices. More than half of Nepal's exports consist of hand-knotted woolen carpets, yarn, jute bags, water and non-alcoholic beverages, lentils, cardamom and wires of iron and non-alloy steel. Around 69 per cent of Nepal's imports consist of capital and technology-intensive

Table 2.36 Trends in exports, imports and trade balance in Nepal, 1980-2010				
	1980	1990	2000	2010
Total trade of goods and services (US$ billions)	0.6	1.2	3.1	7.4
Imports (US$ billions)	0.4	0.8	1.8	5.8
Imports (% of GDP)	18.7	21.7	32.4	36.4
Exports (US$ billions)	0.2	0.4	1.3	1.5
Exports (% of GDP)	11.5	10.5	23.3	9.6
Trade deficit (% of GDP)	-7.2	-11.1	-9.1	-26.8

Source: World Bank 2015g.

goods such as petroleum products, cement, medicines, motorcycles, billets and gold.[41] Travel and tourism is an important component of Nepal's service exports, although its growth has been hampered by inadequate infrastructure.

Sri Lanka

Over the last three decades, the economy of Sri Lanka has performed reasonably well, despite conflicts in its Eastern and Western provinces. GDP increased at an annual rate of over 5.0 per cent and per capita GDP also increased by 2.5 per cent. The main drivers of economic growth were the service and industrial sectors, which growth outpaced GDP. However, the growth rate of the farm sector remained low. Other economic indicators also presented a positive outlook. National savings almost doubled, trade increased by more than seven times and fiscal deficit shrank.

Trends in economic growth

Sri Lanka's economy maintained average economic growth of 5.3 per cent between 1980 and 2010 (see table 2.37). A decade-wise analysis shows a consistent and sustained increase in both GDP and per capita GDP.

In absolute terms, Sri Lanka's real GDP increased by more than four times from LKR3,520 million to LKR16,536 million between 1980 and 2010. Real per capita GDP increased by more than three times from LKR239 thousand to LKR801 thousand during this time.[42]

Such an impressive economic performance is a noteworthy achievement in the presence of conflicts which not only hampered development in directly affected areas, but also hindered the development process in other areas. Security concerns necessitated an increase in defence expenditure, and it rose markedly from 1.4 per cent of GDP in 1983 to 6.0 per cent of GDP.[43] Higher defence spending came at the expense of the social sector, infrastructure and so on. Moreover, conflicts and violence also affected public, private and foreign investment.

Table 2.37 Trends in economic growth (1996 as base year) in Sri Lanka, 1980-2010

	Growth rate (%)		
	GDP	Population	Per capita GDP
1980-90	5.0	1.4	3.5
1990-2000	5.3	1.2	4.1
2000-10	5.6	0.8	4.8
1980-2010	5.3	1.1	4.1

Source: GOS 2014a and MHHDC staff computations.

Sectoral growth

In terms of GDP, between 1980 and 2010, the share of agriculture decreased, while that of services increased. However, as table 2.38 reflects, the share of industry remained almost stagnant. During these three decades, the industrial and service sectors grew at a sustained rate, while the trend reversed in the agricultural sector (table 2.39).

Within the agricultural sector, there has been a significant decline in traditional export crops. Between 1980 and 2010, the shares of tea, rubber, coconut and rice (paddy) declined. This also affected the industrial sector—through the processing industries of tea, rubber and coconut—and shares fell in total manufacturing. Within services, growth occurred in the sub-sec-

Table 2.38 Sectoral shares of GDP in Sri Lanka, 1980-2010

(%)

	1980	1990	2000	2010
Agriculture	27.6	26.3	19.9	12.8
Industry	29.6	26.0	27.3	29.4
Services	42.8	47.7	52.8	57.8

Source: GOS 2014a and MHHDC staff computations.

Table 2.39 Growth rate of economy in Sri Lanka by sector, 1980-2010

(%)

	1980-90	1990-2000	2000-10	1980-2010
Agriculture	4.5	2.4	1.1	2.6
Manufacturing	3.6	5.8	6.4	5.3
Services	6.1	6.4	6.6	6.4
GDP	5.0	5.3	5.6	5.3

Source: GOS 2014a and MHHDC staff computations.

tors of wholesale and retail trade, transport and communications, and banking, insurance and real estate.[44]

Savings and investment

Conflicts and violence in Sri Lanka adversely impacted investment and it plummeted accordingly from 33.8 per cent of GDP to 28.0 per cent between 1980 and 2010. However, investment is still higher than in most South Asian countries. National savings almost doubled during this period, from 14.0 per cent of GDP to 25.3 per cent. This positive trend is reflected both in domestic savings and foreign remittances (see table 2.40).

Table 2.40 Trends in savings and investment in Sri Lanka, 1980-2010

(% of GDP)

	1980	1990	2000	2010
Gross investment	33.8	22.2	28.0	27.6
.Public	7.6	4.2	3.3	6.2
.Private	25.0	18.0	24.8	21.4
Gross domestic savings	13.5	14.3	17.4	19.3
Gross national savings	14.0	16.8	21.5	25.3

Sources: GOS 2010a, 2014a and 2014d and MHHDC staff computations.

Table 2.41 Trends in public finance in Sri Lanka, 1980-2010

(% of GDP)

	1980	1990	2000	2010
Total revenue and grants	23.5	23.2	17.2	14.9
.Tax	18.3	19.0	14.5	12.9
Total expenditure	42.7	31.0	26.7	22.9
.Recurrent	18.5	22.3	20.2	16.7
.Capital and net lending	24.2	8.7	6.5	6.1
Budget deficit	-19.2	-7.8	-9.5	-8.0
Public debt	77.2	96.6	96.9	81.9
.Domestic	43.7	41.6	53.8	45.8
.External	33.5	55.0	43.1	36.1

Source: GOS 2014a and MHHDC staff computations.

Table 2.42 Trends in exports and imports in Sri Lanka, 1980-2010

Value (US$ billions)			Annual compound growth rate (%)		
	Exports	Imports		Exports	Imports
1980	1.1	2.1	1980-90	6.4	2.7
1990	2.0	2.7	1990-2000	10.8	10.5
2000	5.5	7.3	2000-10	4.6	6.3
2010	8.6	13.5	1980-2010	7.2	6.5

Source: GOS 2014a and MHHDC staff computations.

Government revenue and expenditure

The government has taken a number of steps to develop the taxation system that have proven relatively ineffective. Between 1980 and 2010, total revenue as a percentage of GDP gradually declined from 23.5 per cent to 14.9 per cent (see table 2.41). One reason for this drop was more dependence on indirect taxes, which accounted for about 80 per cent of total taxes.[45] Meanwhile, as table 2.41 details, total expenditure declined significantly—from 42.7 per cent in 1980 to 22.9 per cent in 2010. This was mainly a consequence of huge cuts in capital expenditure, which decreased by a factor of four. Declining expenditure reduced the fiscal deficit in Sri Lanka. Over the last three decades from 1980 to 2010, the budget deficit decreased from 19.2 per cent of GDP to 8.0 per cent.

One consequence of insufficient tax revenue was an increase in public debt, which rose from 77.2 per cent of GDP in 1980 to 81.9 per cent in 2010, mostly in terms of external, as opposed to, domestic debt. The share of domestic debt as a percentage of total debt increased from 43 per cent to 44 per cent between 1980 and 2010.

Trade

Between 1980 and 2010, table 2.42 shows that merchandise exports grew from US$1.1 billion to US$8.6 billion, increasing by 7.2 per cent per annum, while imports also expanded from US$2.1 billion to US$13.5 billion, but at a lower annual rate of 6.5 per cent.

Exports as a percentage of GDP fell from 26 per cent to 17 per cent between 1980 and 2010, while imports as a percentage of GDP decreased from 51 per cent to 27 per cent during this period. This clearly shows the poor performance of trade in terms of its contribution to GDP.[46]

During this period, the composition of exports changed significantly. The share of agricultural exports in total merchandise exports decreased steeply from 62 per cent to 27 per cent, while industrial exports increased from 33 per cent to 71 per cent. In the case of merchandise imports, in 2010, consumer goods comprised 18.4 per cent of total imports, intermediate goods stood at 59.9 per cent, and investment goods made up 20.5 per cent.[47]

The US, UK, and EU are the main export destinations of Sri Lanka. Garments are the main export to these countries. In the case of imports, India, Singapore, China, Iran and Japan are the top import sources.[48]

Economic growth by province

Administratively, the country is divided into nine provinces: Western, Central, Southern, Northern, Eastern, North Western, North Central, Uva and Sabaragamuwa. The Western Province covers the smallest land area, but is the most developed in terms of its contribution to national GDP and population. In 2010, it made up 28 per cent of Sri Lanka's population and 45 per cent of GDP (see table 2.43). Similarly, it accounted for half of the output from both the country's service and industrial sectors.

Per capita GDP is also the highest in the Western Province at LKR428 thousand, nearly twice the value for the Southern Province, the second highest. However, this value is 2.7 times more than the value for Northern, the poorest province with a value of LKR159 thousand. Since the end of the civil war in the Northern and Eastern provinces in 2009, there have been signs of economic revival, on account of increased public investment for infrastructure.[49]

Section 3: Conclusion

Over the last three decades, GDP in South Asia increased at an annual rate of 5.9 per cent, making it one of the fastest growing economic regions of the world, second only to East Asia and the Pacific. Most of this growth was driven by India, the largest economy of South Asia. Such an impressive performance shows the potential of South Asia to reach the annual growth rates that have typified East Asia, of 7 to 10 per cent , and more importantly, to sustain them in the coming decades. For this, the region needs sound macroeconomic management, policy and institutional reforms, and targeted public investment.

Economic management in all South Asian countries needs to be improved. The focus should be on better resource allocation, reducing corruption, taxing the rich, cutting unnecessary subsidies, and establishing institutions to implement and monitor reforms.

The following are some of the drivers of growth, which if properly managed, can improve and sustain South Asia's economic future.

Demographic dividends: The share of the working population in South Asia's total population will continue to increase in the coming decades. This can help boost and sustain economic growth if governments invest in human capital and create the requisite employment opportunities. Within South Asia, the evidence is clear from the information technology (IT) and business processing outsourcing (BPO) sector in

Table 2.43 Per capita GDP, population, land area and GDP in Sri Lanka by province, 2010

	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabaragamuwa
Population (% of total)	28.4	13.0	12.1	5.8	7.6	11.3	6.0	6.4	9.4
Land area (% of total)	5.7	8.9	8.6	13.2	14.9	12.0	15.5	13.3	7.8
GDP (% of total)	44.8	10.0	10.7	3.4	6.0	9.5	4.8	4.5	6.3
Per capita GDP (LKR thousands)	428	209	240	159	214	228	215	191	181

Sources: GOS 2011c, 2013d and 2014e and MHHDC staff computations.

South Asia needs to integrate economically by promoting deeper trade and transit arrangements and by developing common trade infrastructure

India (see chapter 3) and the RMG sector in Bangladesh, as both have benefitted tremendously from the presence of skilled labour while contributing to economic growth.

The services revolution: The service sector has great potential, as has been evident from India's success in establishing a niche for itself in the fast-growing global software and information technology market. The revolution of mobile phones has changed the lives of the poor, with a significant impact on their economic activity. Also, the information and communications technology (ICT) sector has changed the dynamics and functioning of financial services.

Domestic savings, investment and remittances: The region has to envision a monetary policy to encourage savings and increase investment. In East Asia, savings as a percentage of GDP exceeded 30 per cent during their take-off period in the 1970s and the 1980s, which then contributed significantly to economic growth. This is not difficult for South Asia, as the saving rate in India and Bangladesh has already exceeded 30 per cent. Provided that the region creates more employment opportunities for the growing working population, the dependency ratio will go down and in turn, household incomes and savings will increase. This, along with financial deepening and an upsurge in corporate profits, can increase saving and investment in the future. Another important determinant is rising remittances, which continue to have a positive impact on national savings in South Asia.

Productivity gains will be crucial to build upon and sustain economic growth in the future. Thus far, growth in the region has been centred on low productivity and labour-intensive economic activity. Growth in total factor productivity has been the key growth driver in East Asia and China. South Asia has ample scope for catching up through productivity increases, which can steer the region onto a permanently higher growth trajectory. In this context, the role of human capital, trade liberalisation, financial deepening and ICT is important.

Regional economic integration would result in enormous economic benefits for all. South Asia is one of the least integrated regions of the world: intra-regional trade accounts for less than 5 per cent of South Asia's total trade, as compared to 32 per cent in East Asia. Similarly, intra-regional FDI is only 1 per cent of South Asia's total FDI and is not comparable to the 35 per cent levels of investment in East Asia. South Asia needs to integrate economically by promoting deeper trade and transit arrangements and by developing common trade infrastructure. A well-connected region can boost trade with China and the Association of South East Asian Nations (ASEAN). This will also create economic constituencies in the two biggest economies of the region, India and Pakistan, encouraging them to overcome their historical enmities. Moreover, it will help the region to promote tourism; currently, South Asia accounts for only 1.1 per cent of global tourist traffic.