**SERVICE SECTOR DEVELOPMENT TO SUPPORT HIGH GROWTH IN A TRANSFORMING ECONOMY**

Background Paper for the 2041 Perspective Plan. Prepared for the General Economics Division of the Planning Commission, Government of Bangladesh

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SERVICE SECTOR DEVELOPMENT TO SUPPORT HIGH GROWTH IN A TRANSFORMING ECONOMY

# OVERVIEW

The services sector is an integral part of the Bangladeshi economy. It provides a convenient bridge for the transformation of the rural agrarian economy to a primarily urban industrial economy. In a typical transformation path, as the agriculture sector modernizes, labor transits initially from agriculture to mainly low-skill rural and urban services. These services, mostly informal in nature, provide a cushion for labor absorption as agricultural employment shrinks. The labor thus released from agriculture eventually either retrains and gets distributed to manufacturing and modern services, or stays put in informal services. The growth of services activities and employment is primarily a function of demand. In today’s global world where labor and capital are mobile, both domestic demand and world demand matters for the expansion of the services sector.

A striking aspect of the development of the services sector in Bangladesh is that it not only has responded well to the growing demand emerging from the growth of manufacturing and agriculture activities, it has also positioned itself well in the global market for low-skilled workers, especially to the oil-rich middle-eastern markets. As a result, there has been a rapid inflow of worker remittances that has fueled a huge demand for construction activities and for a range of services in both urban and rural areas. This inflow of remittances has played a major role in transforming the rural economy and contributing to poverty reduction (Ahmed 2015).

The services sector itself is transforming. As Bangladesh transited from a low-income developing country at the time of independence in 1972 to a lower middle income country in 2015, the services sector has been steadily transforming from a primarily low-productivity, low-income unorganized services sector dominated by trade, transport and low-end personal services towards more organized and higher-income commercial services. In addition to the standard organized service activities provided by the public sector through public administration, defense, law and order, education and health services, the private services sector has undergone a slow but steady structural change in the form of growth of a range of modern commercial activities including banking and other financial services, shipping, Information Communications Technology (ICT), aviation, storage, tourism and hospitality services. Nevertheless, this transformation is rather slow and falls short of what has been achieved in the neighboring India. This is a missed opportunity that will need to be comprehensively addressed in order to facilitate the transformation of the Bangladesh economy to a high-income economy.

This paper looks at the developments in the service sector in terms of major achievements in growth, employment, exports and rural transformation and provides a strategy for further dynamizing the services’ sector role over the next 24 years as Bangladesh aspires to achieve high-income status by FY2041. The paper suggests the required policy and institutional reforms needed to implement this strategy. It also provides and outlook for the services sector with a view to supporting high growth in a transforming economy

# THE PERFORMANCE OF THE SERVICES SECTOR

The contribution of the services sector to the development of the Bangladeshi economy can be seen from its contribution to four main areas: GDP growth; employment; exports; and rural transformation. These aspects are inter-related and tend to reinforce each other.

## Contribution to GDP Growth

One striking aspect of the services sector in Bangladesh is that unlike the conventional wisdom that valued-added and growth in services activities follow the growth in agriculture and manufacturing, the services sector has been a growth leader during most part of the economic development since independence. This is illustrated in Figure 1. In the early years after independence, as the relative role of agriculture fell, the services sector expanded rapidly, growing much faster than total GDP and its relative share rocketed from 31% in FY1974 to 50% in FY1980. The services sector continued to grow faster than GDP until FY2010, when its relative GDP share reached 55%. The growth has now slowed slightly below the pace of GDP growth. Consequently, the GDP share of services sector is declining has fallen to 53% in FY2017. Even so, this 70% increase in the relative GDP share of services is a remarkable achievement and has been a major contributor to income, employment and poverty reduction.

##### Figure 1: GDP Share of Services (constant market prices)

 ***Source: Bangladesh Bureau of Statistics***

The strong performance of the services sector can also be seen in the context of international comparison. Based on the work of the well-known economist, W. W. Rostow (1950), the conventional expectation is that a poor agrarian economy initially moves to a path of growth take-off based on the strength of the industrial sector and then eventually when it achieves self-sustained growth the role of services sector expands. In contrast to this, in Bangladesh, India and other South Asia, the services sector played a stronger role than the industrial sector in the early stages of development. As a result, the share of services value-added in total GDP is higher than the average for the low income economies (Figure 2)[[1]](#footnote-1).

##### Figure 2: Role of Services Sector, 2015 (% of GDP)

 ***Source: World Development Indicators, 2017, World Bank***

## Contribution to Employment

The employment contribution of services sector is illustrated in Figure 3. Unlike the analysis of traditional migration models (Lewis 1950; Fei-Ranis 1964), the services sector provided the initial cushion to absorb the surplus labor released from agriculture[[2]](#footnote-2). This was particularly true during the early years. Surplus agriculture labor initially moved to a range of rural and urban services in trade, transport and personal services. Thus the employment share of services surged from 15% in FY1974 to 34% in FY1990. It has continued to grow somewhat faster than total employment since then, although the pace was considerably less rapid than during the FY1974-FY1990 period. A part of the slowdown service sector employment growth post FY1990 is explained by the RMG revolution that gained momentum during the 1990s. But another contributing factor was external migration, primarily to Middle Eastern Countries (Figure 4). Along with internal migration to urban sector jobs, the external job creation through migration has been a major contributor to the tightening of labor market in the rural economy and resultant increases in agricultural wages (Ahmed, 2015)

##### Figure 3: Employment Share of Services

***Source: Bangladesh Bureau of Statistics***

##### Figure 4: Annual Outflow of Migrant Workers

 ***Source: BMET***

## Contribution to Exports

The services sector has been a major driver of exports. The main contributors have been export of workers and a range of non-factor services (NFS). The trend in these sources of export earnings is illustrated in Figure 5. Export of workers and related remittance inflows took off in a big way after FY1990. Other service exports have also shown some upward movement, but income from remittance inflows has dwarfed the contribution from other services. Remittance inflows reached a peak of $15.2 billion in FY2015, growing by an annual average rate of 12.5% in nominal dollar terms between FY1990 and FY2015. Other service export income also grew significantly although at a more modest pace of 8% per year.

##### Figure 5: Trend in Factor and Non-Factor Service Exports

 ***Source: Bangladesh Bank***

Income from remittances and other services is a major source of exports and an important driver of GDP growth. Before the emergence of ready-made garments (RMG), services were the largest source of export earnings (Figure 6). This dominance prevailed even after the arrival of RMG well until FY2010.

The relative role of remittances and other service earnings has fallen considerably since then, owing to a slowdown in the growth of remittance income followed by a sharp decline since FY2016 caused by falling average income, foreign currency fluctuations and capital flight. The services export earnings as a share of GDP fell from a peak of 12.2% in FY2010 to only 6.7% in FY2017 (Figure 7). Even so, they still constitute the second largest source of export earnings after RMG, accounting for 32% of total export earnings in FY2017.

##### Figure 6: Role of Services Exports

 ***Source: Bangladesh Bank***

##### Figure 7: Earnings from Services Exports as % of GDP

 ***Source: Bangladesh Bank and Bangladesh Bureau of Statistics***

The solid contribution of services sector to export earnings is self-evident. The challenge moving forward is how the recent decline in service export earnings can be reversed and its historical dynamic role preserved and further expanded, especially focused on NFS. Unlike earnings from factor services that are largely exogenous to Bangladesh because they depend upon immigration policies of host countries, earning potential from NFS is substantial. The global market for NFS is large and Bangladesh is a relatively small player. With proper policies it should be possible to capture a larger share on the global NFS market

## Contribution to Rural Transformation

Over the past 40 years the rural economy of Bangladesh has undergone an amazing transformation. Poverty has declined substantially, life expectancy has increased by a large number of years and adult literacy has improved significantly (Ahmed 2015). The substantial improvements in the fundamental indicators of well-being of the rural population were also accompanied by enhancements in the quality of life in terms of quality of dwelling, access to safe water, access to sanitary facilities, access to electricity, access to rural roads, access to telephone, access to internet, better health facilities and growing education of rural children at the primary and secondary level. The Bangladesh rural economy and the social scenario today are vastly different from the 1970s.

Along with social progress, the sources of income have changed dramatically (Ahmed 2015). Agriculture is no longer the dominant source of income. The rural households now draw a substantially larger proportion of their income from non-agricultural activities and transfers, mainly from foreign migrant workers. The effects of growing demand for services in the rural economy financed by the remittance and non-farm income is adding a new dimension to employment opportunities for services in rural areas. The observed improvement in the quality of life of the rural population in terms of housing, rural infrastructure, health and education is an example of the growing demand for services. The expansion in rural electrification, cell phone and internet services is also changing the economic and social character of the rural population.

The emphasis on food production from the early years of independence has been a hallmark of public policy in Bangladesh that has served well the cause of poverty reduction overall, but especially in rural areas (Lipton 2015; Ahmed 2015). Investment in irrigation and rice technology has yielded huge dividends. Rice production soared from a low of only 9.3 million metric tons in 1972 to a remarkable 34.8 million tons in 2016. Along with production of wheat (1.2 million metric tons in 2016), per capita foodgrain availability almost doubled from 133 kilogram per person per year in 1972 to 260 kilogram in 2016. This rapid expansion of food per capita has been an important contributor to the sharp reduction in the incidence of mass hunger and poverty. Due to land constraint, acreage under food production did not increase much (less than 1% per year) but production growth mostly came from a strong increase in productivity. As a result of adoption of better production technology (seeds, fertilizer and water based green revolution) and multiple cropping, per acre rice productivity increased from only 403 kilograms in 1972 to 1230 kilograms in 2016, which is a three-fold growth. This productivity improvement along with generous input subsidies has helped keep the price of rice low for consumers. The productivity growth and subsidies protected farmer income and incentives from falling while low rice prices protected the consumers, especially the poor who have a much larger share of foodgrain in their consumption basket than the non-poor.

Fertility decline and growth of food production explain the developments in rural Bangladesh between 1972 and 2000 quite well. From 2000 onwards, other dynamic factors have started playing a more dominant role in changing the rural landscape. To appreciate their role, it is instructive to look at the sources of rural household income (Table 1). While there are concerns about the accuracy of the income data, especially those reported in the 2010 HIES, the directional changes are informative. These directional changes are also consistent with the independently prepared national accounts data. HIES Data suggest that even as late as 1991 farming accounted for some 53 percent of rural household income. By 2010, this share had fallen dramatically to only 30 percent, whereas the share of non-agricultural income surged from 36 percent to 53 percent (BBS 2010). The other important and growing contributor is total transfers from domestic and foreign sources, which expanded from 11 percent in 1991 to 17 percent in 2010. Much of this transfer is accounted for by the contribution from foreign remittance. Thus in 2010 some 70 percent of total transfers came from foreign remittances.

#### Table 1: Sources of Rural Household Income (percent)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Year** | **Total Household Income** | **Agriculture** | **Non-agriculture** | **Transfers** | **(Foreign Remittances)** |
| 1991/92 | 100 | 53 | 36 | 11 | (4) |
| 1995/96 | 100 | 47 | 43 | 10 | (5) |
| 2000 | 100 | 35 | 53 | 12 | (8) |
| 2005 | 100 | 34 | 51 | 14 | (9) |
| 2010 | 100 | 30 | 53 | 17 | (12) |

***Source: BBS, HIES (various years)***

This is corroborated by developments in national accounts that show that as compared with agriculture, which grew by an average of 3.4 percent during FY1992-FY2010, manufacturing grew by 7.3 percent and services by 5.9 percent (i.e. both grew much faster than agriculture). The employment share of agriculture also fell while the employment share of manufacturing and services grew. Importantly, the value of remittance inflows nearly tripled between 2005 and 2010 in US dollar terms, thus corroborating the HIES reported increase in the share of remittance income in total household income.

These changing income trends suggest a huge economic transformation of the rural economy as non-farming activities have become the dominant source of income in the rural areas. While the income from farming tends to be more equalizing than income from non-farming and transfers, once the general equilibrium effects of growing demand for services in the rural economy financed by the remittance and non-farm income is considered, the most likely beneficiary of this is the rural wage earners, who tend to belong to the poorest income group. The observed improvement in the quality of life of the rural population in terms of housing, rural infrastructure, health and education is an example of the growing demand for services.

The expansion in rural electrification, cell phone services and internet services is also changing the economic and social character of the rural population. Better communications along with improvement in rural transport has lowered the transaction costs between the rural and the urban centers, thereby facilitating the expansion of trade and commerce. The expansion of ICT services to the rural economy is slowly but surely reducing the information gap between the urban market centers and rural production points and also helping improve production technology. Additionally, the expansion of mobile financial services is changing the payments options. Both are helping reduce cost and secure better returns to rural entrepreneurs.

# EMERGING ISSUES AND CHALLENGES IN THE SERVICES SECTOR

Notwithstanding the past solid performance of the service sector, there is substantial scope for further dynamizing the contribution of this sector to the development of Bangladesh, especially in terms of growth and equity. The quality and productivity of the services sector must enhance tremendously to provide the necessary growth and employment support to ensure the successful completion of the aspired journey for Bangladesh from low-middle income to upper middle income by FY2031 and High Income by FY2041.

There are a number of issues and challenges that need to be addressed to facilitate this journey. First, despite some progress with modernizing the services sector, it remains dominated by unorganized activities where productivity and incomes are low. Much of the workforce outside agriculture who are considered poor are engaged in these low-productivity, low-income unorganized services in rural and urban areas. Second, the skill base of the services sector, although better than in agriculture and manufacturing, is still low that largely explains the dominance of unorganized, low productivity, low income activities. Third, while earnings from export of labor services have done very well, the performance of export earnings from NFS is considerably below potential. Fourth, the regulatory policies and public institutions for supporting the expansion of modern services require substantial revisions and upgrading in order to fully exploit the benefits of a modern and dynamic services sector.

## The Structure of Services Sector

The structure of services sector is shown in Table 2. Trade is the dominant services activity, growing at a faster pace than total GDP between FY1974 and FY2010, with its share in GDP reaching 14 percent. Since then its GDP share stabilized at around 14%, growing at the same pace as total GDP. The increasing importance of trading activities can be gauged from the fact that its GDP share in FY2017 exceeded the GDP share of agriculture and forestry combined. The expansion of trading activities has benefitted from a very flexible and fairly liberal entry/exit business environment of the sector. The investment requirements are relatively low and also flexible because scale can be adjusted easily to fit the available financing. Trading is a major source of rural non-farm employment and income.

The other important source of growth in services sector is personal and community services. Its GDP share climbed from 6.2 percent in FY1974 to a high of 11.1% in FY2010, before falling down to 8.9 percent in FY2017. The expansion of personal services is the direct outcome of a buoyant Bangladeshi economy and the generous inflow of remittances. The demand for a range of personal services including chauffeurs, plumbers, shoe-repair, informal electrician, tailoring, household support staff, hair dressing, beauty salons and parlors and the like have mushroomed all over urban Bangladesh, especially in the high income metropolitan cities of Dhaka and Chittagong. The high income elasticity of demand for these services and plentiful supply makes this a very vibrant source of income and employment. Wage data from the 2015-16 Labor Force Survey shows that the average wages in non-household informal activities tend to be higher than average wages in manufacturing, even though this is largely an informal source of employment (BBS 2017). As in the case of trading, the highly flexible employment market with almost no regulatory intervention has contributed to the expansion of this activity, with value-added growing faster than average GDP on a trend basis. Also, the investment requirements are minimal. However, the skill requirements are significantly more stringent than in unorganized trading. Nevertheless, except in the case of chauffeurs where a driving license is required, all other skills are learnt through on- the- job training without any formal licensing or certification in most cases.

#### Table 2: The Structure of Services Sector (% of GDP at factor cost)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Activities** | **FY1974** | **FY1980** | **FY1990** | **FY2000** | **FY2010** | **FY2017** |
| Trade | 9.3 | 11.0 | 11.8 | 12.8 | 14.0 | 13.9 |
| Transport | 4.2 | 8.1 | 8.7 | 8.1 | 8.9 | 8.6 |
| Telecoms | 0.2 | 0.2 | 0.4 | 0.8 | 2.1 | 2.6 |
| Financial Services | 1.0 | 1.5 | 1.5 | 1.5 | 2.9 | 3.4 |
| Real Estate | 4.9 | 10.2 | 9.7 | 8.5 | 7.6 | 6.5 |
| Public Administration | 1.0 | 1.5 | 2.0 | 2.5 | 3.3 | 3.7 |
| Education | 1.6 | 2.1 | 1.9 | 2.1 | 2.2 | 2.5 |
| Health | 1.2 | 2.5 | 2.3 | 2.1 | 2.0 | 1.8 |
| Hotels and Restaurants | 0.2 | 0.5 | 0.6 | 0.6 | 0.8 | 0.8 |
| Personal and Community Services | 6.2 | 10.7 | 9.5 | 7.8 | 11.1 | 8.9 |
| **Total Services** | 30.9 | 48.3 | 48.4 | 46.8 | 54.9 | 52.7 |

***Source: Bangladesh Bureau of Statistics***

The third major service activity is the transport sector. Following an immediate expansion between FY1974-FY1980, on average the transport sector has underperformed. The major transport components are shown in Table 3. Land transport seems to have performed well, growing faster than overall GDP, but water and air transport have performed poorly. Even in land transport, there are major performance issues in road infrastructure and rail services.

#### Table 3: Composition of Transport Sector Value-Added (% of GDP at factor cost)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Transport Mode/Activity** | **FY1980** | **FY1990** | **FY2000** | **FY2010** | **FY2014** |
| Land | 5.3 | 6.2 | 6.4 | 7.3 | 7.2 |
| Water | 2.5 | 2 | 1.1 | 0.9 | 0.7 |
| Air | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 |
| Storage etc. | 0.2 | 0.3 | 0.4 | 0.6 | 0.6 |
| Total transport | 8.1 | 8.7 | 8.1 | 8.9 | 8.6 |

***Source: Bangladesh Bureau of Statistics***

The rapid decline in the share of water transport underscores the huge neglect of this mode of transportation. Given the large network of waterways in Bangladesh, river transport serves a major development role in terms mobility of rural people and commodity flow. It can also be a dynamic source of employment and poverty reduction for the rural poor. With the growing congestion of road network and limited capacity of rail cargo services, water transport provides a huge, environmental friendly alternative that has been by-passed.

There are several factors that have constrained the performance of river transport (Government of Bangladesh, 2017). The most important factor is the limited navigability of many riverways owing to the growing incidence of siltation. Huge investments are needed for river dredging to make them navigable and conducive to the use of modern river vessels. A second factor is the inadequacy of safety standards to protect people and cargoes from accidents. Many river vessels have questionable river-worthiness features. Additionally, the frequency of over-loading is huge. Due to absence of adequate monitoring and enforcement, safety standards are frequently violated resulting in accidents that cause substantial loss of life and property. Collusive behavior of safety inspectors and vessel owners further add to the problem. Because of safety concerns a large amount of potential river traffic tends to get diverted to land transport that further adds to the congestion problem. A third problem is the inadequacy of river ports and cargo holding capacities. It is obvious that a combination of major investments in river dredging and river ports combined with effective monitoring and implementation of safety standards will substantially improve the quality of water transport and spur private investment and value-added.

Regarding air transport, the main constraint is the weak performance of the national carrier Bangladesh Biman. The demand for air transport has swelled at both the international and domestic level. Yet, the capacity constraints of the national carrier Bangladesh Biman are severe. Notwithstanding numerous reform efforts, the management problems of Bangladesh Biman remain overwhelming. Consequently, fleet capacity, reliability and service quality are very weak. As a result, it has not been able to benefit much from the large growth in the demand for both international and domestic travel. High-performing international carriers, especially Emirates, Etihad and Qatar Airways, have captured the bulk of the market share of international travel to and from Bangladesh. In the area of domestic air travel, the government deregulated air operations to allow for national based private air services. The response has been positive but inadequate. A major constraint is investment. Air services are highly capital intensive and also require special skills, the absence of which tends to make domestic private investment hesitant to enter this high-risk sector. The inadequacy of domestic air connectivity combined with heavily congested land transport is a major constraint to the growth of the tourism industry.

A fourth large contributor to services GDP is the real estate sector. It has generally been on an upward trend since FY1974, achieving its fastest growth during the first 10 years after independence. As a result, its GDP share surged from 4.9 percent in FY1974 to 10.2 percent in FY1980. The activities of the real estate sector got a boost from the inflow of remittances. Also, with growing urbanization, the demand for urban housing and urban office space has surged. The supply of real estate services has responded adequately to the demand and the market works competitively. However, speculative activities over the 2007-10 periods caused an over-investment in high-cost urban housing projects that have created a market bubble. Real estate prices and urban housing rents have moderated in response to this bubble, causing a slowdown in the growth of real estate activities.

Additionally, there are major policy constraints that prevent the emergence of a modern and efficient real estate market. First concerns the inadequacy of home loan mortgage services and the second is the inadequacy of enforcement of zoning regulations. The inadequacy of long-term home mortgage options reduces the effective demand for housing services, while the ineffectiveness of zoning regulations reduce the quality of real estate services with excessive bias towards commercial real estate services. This in turn contributes to the weakness of urban development.

The low value-added of education and health services despite growth of these services is a worrisome development. This largely reflects the expansion of low quality services in both areas. While the composition of activities in both sectors has changed substantially with a growing share of private provision, the average service quality and inputs remain low. The inadequacy of tertiary education in science and technology area is emerging as a major constraint to the expansion of quality manufacturing and high-value-added service exports. In the area of health, the absence of modern health financing options, such as health insurance, is an important constraint to the more rapid expansion of higher value health services.

One major service industry not directly reflected in the service sector value-added is the role of tourism. While the international travel-related effects of tourism are captured through the travel receipts in the service account of the balance of payments, other aspects of tourism linked hospitality services and domestic transport are captured in transport, hotels and restaurants. Additionally, there are large indirect effects linked to tourist spending on travel, hotels, food, and purchases of other local goods and services. Research shows that the multiplier effects of tourism can be large as reflected in the role of tourism in such economies as Thailand and Malaysia (WTTC 2017a).

## Structural Change in Services

One important question is the extent of modernization of the services sector. In addition to the traditional definition of formal services sector that mostly includes public administration, public health and public education, in each category of service there is a mix of formal and informal provision. The absence of data makes it difficult to fully understand the extent of modernization of the services sector. In view of this limitation, the modernization is defined more specifically to include the formal public sector and the growth of a range of private sector services that are well organized and registered with the government, that is much more skill based, that involves better technology and that are relatively more capital intensive. These activities include Telecoms and ITC, banking and financial services, aviation industry, international shipping, hospitality industry (hotel and restaurants) and modern storage and transport support services. Each of these activities holds considerable growth prospects and can cater to both domestic and international demand.

The expansion of high potential modern service activities is indicated in Figure 8. Starting from low base values in FY1990, all services, except healthcare and air transport, have grown faster than GDP. The financial sector in particular has done well, thereby acquiring a rapid increase in its GDP share. Storage and transport support services and telecoms/ITC services have also performed well. However, in comparison to its potential ITC and telecoms services have under-performed. International shipping also has under-performed. Hospitality service growth has shown some momentum starting from its tiny base value, but compared to potential it has under-performed. Along with domestic air travel, it constitutes another constraint to the expansion of tourism activities. The failure of healthcare services to grow faster than GDP is a worrisome development that requires special policy attention. In high income countries healthcare tends to be one of the most dynamic and high value-added activity.

The growth of high-potential services is beginning to make an impact in terms of modernization of the services sector. Thus, the share of modern services has expanded from 18 percent in FY1990 to 30.3 percent in FY2017 (Figure 9). Much of the growth has come from private-sector led modern services involving finance and technology. Nevertheless, as noted, most of these services are under-performing relative to domestic and international demand. In particular ITC, hospitality services, shipping and aviation services can considerably expand by taking advantage of considerable global demand for these services. Additionally, housing, healthcare and education will need to create the basis for supporting the skills base and the technology base to spur the development of the manufacturing sector.

##### Figure 8: Evolution of Modern Services (% of GDP)

 ***Source: Bangladesh Bureau of Statistics***

##### Figure 9: Structural Change in Services

 ***Source: Bangladesh Bureau of Statistics***

Commensurate with its growing importance in the economy, the employment share of modern services has also increased significantly over the years (Figure 10). The growth has been particularly dramatic since 2010. This is an important indication of the slowly improving services sector employment base. Yet, this performance has to gather momentum if Bangladesh were to achieve high-income status.

##### Figure 10: Transformation in Services Employment (% of Total Services)

 ***Source: Bangladesh Bureau of Statistics***

## The Productivity Challenge in Services

Apart from the specific need to expand the contribution of high-potential services in the economy, there is the more general challenge of increasing the productivity of services activities. Professional and skill-intensive services such as banking, finance, ICT, healthcare, education, shipping and aviation tend to be high productivity, high income activities. As noted above, the role of these activities is still limited despite recent growth. Other services like trade, transport and personal services have done well but generally they tend to be dominated by low productivity, low skills and unorganized activities.

In order to provide a reference point, it is first important to look at how average labor productivity economy wide in Bangladesh compares internationally across key trading competitors. This is shown in Figure 11. To make comparisons meaningful, GDP is measured in purchasing power parity (PPP) terms. The good news is that Bangladesh has made important progress in improving average labor productivity between 1991 and 2016. The bad news is that there is still a lot of catching up to do to approach the productivity levels of competitors. Average labor productivity in Bangladesh is 53 percent lower than in India; 69 percent lower than in China; 75 percent lower than in Sri Lanka and 86 percent lower than in Malaysia. Increasing average labor productivity is perhaps the biggest challenge facing Bangladesh in aspiring to reach higher income in the next 24 years.

##### Figure 11: Average Labor Productivity (2011 PPP$)

 ***Source: World Bank Database, 2017***

Looking at the Bangladesh sectoral productivity, the average labor productivity in manufacturing is the highest, followed by services (Figure 12). Not surprisingly, average productivity is the lowest in agriculture, which pulls down the average productivity nationwide and partly explains the observed very low average labor productivity at the international comparator level. The average productivity differentials across sectors are reasonable. The development process involves labor transfers from the lowest productivity activity (agriculture) to medium average productivity activity (services) and then eventually to the highest productivity activity (industry).

##### Figure 12: Trend in Average Labor productivity, 1995/96 prices

 ***Source: Bangladesh Bureau of Statistics***

The aggregate services is a mixed bag of very high (modern services) to low productivity activities (trade, transport, education services). Owing to data limitations, productivity estimates are possible for only selected services (Figure 13). But it tells a powerful story.

##### Figure 13: Average Productivity of Selected Services FY2016

 ***Source: Bangladesh Bureau of Statistics***

As expected, there are large productivity differentials within the services category. Highest productivity is found in professional services, such as Finance, Telecoms and ICT. The lowest productivity is in education, followed by trade and transport. The productivity differential between trade and finance is as high as 554%. The surprising result is the low productivity of education. This basically reflects the dominance of low-quality primary and secondary education activities. Tertiary education, especially science and technology is still a small share of the total education activities in Bangladesh

Productivity differentials show up in average earnings (Figure 14). Not surprisingly, average monthly earnings are the lowest in low productivity trade and transport; while they are the highest in finance and ICT. This pattern is true for both male and female, although the earnings differentials between male and female vary quite significantly by profession. One surprising result is the large gap between productivity and earnings in education. Despite very low productivity, the earnings level is quite high in education relative to trade and transport. This is explained by the fact that unlike trade and transport that are mostly unorganized and informal in nature, much of the education is in the formal sector. Most education sector employees are primary and secondary school teachers in the public sector.

##### Figure 14: Earnings Profile by Activities FY2015-16 (taka)

 ***Source: LFS, 2015-16 Bangladesh Bureaus of Statistics***

The productivity challenge in the services sector is clear. According to LFS 2015-16, trade and transport account for 57% of total services employment. An additional 5% are employed as household staff. Combining these low productivity workers with the low productivity outcome of education services (10% of the work force), some 72% of services sector employment suffers from low average productivity. Modernizing and upgrading the quality of this 72% of the service sector employment is a major challenge.

## The Skills Challenge in Services

The low productivity in trade, transport and personal services when compared with the high productivity in professional services (ICT, Telecoms, finance, etc) is largely explained by the skills differentials between these activities. On average, the professional services are characterized by labor force with tertiary degrees and other professional and specialized training. In contrast, the average education level in transport, trade and personal services is very low. Figure 14 shows the education attainments of employed labor in Bangladesh. The Figure 15 shows that some good progress has been achieved in improving the education profile of the work force but the gaps remain alarming. Some 33 percent of the Bangladesh labor force had zero education even as late as FY2016. This number is as high as 44 percent in agriculture. About 23 percent have only primary education, while 31 percent have secondary education. Only 12 percent have tertiary level education (higher secondary and above). On average the education attainments of the service sector is better than industry and agriculture. For example, on average, some 22 percent of services workers have tertiary level education as compared with 9 percent in industry and only 3 percent in agriculture.

##### Figure 15: Education Profile of the Workforce

 ***Source: LFS, 2010; LFS 2015-16. Bangladesh Bureau of Statistics***

Some further insights on the skills challenge in the services sector can be obtained from the combined analysis of the 2010 Labor Force Survey data and the 2010 HIES data. The LFS 2010 suggests that some 79 percent of labor force engaged in services sector is informal in nature. The level of formality varies considerably by occupation, with most informal activities concentrated in trade, transport and personal services (over 90 percent of activities are informal in nature) while activities in financial sector, education, real estate and public administration are mostly formal ( 60-80 percent). According to HIES 2010, the average years of schooling for formal workers are 10.1 years among public sector employees and 5.9 years among private sector employees. In contrast, informal workers, including day laborers and self-employed, have 2.1 and 4.2 years education on average. In 2010 there were some 15 million day laborers and 20 million self-employed in the workforce. Some 9.7 million day laborers and 8.9 million self-employed had no education at all. A World Bank Survey of reading assessment of rural non-farm workers conducted in 2009 showed that some 77 percent of non-farm day workers and 57 percent of no-farm self-employed could not read (World Bank 2013). The large bulk of these informal workers and self-employed are engaged in the services sector. These data are indicative of the skills challenge of the service sector as well as the broader skills challenge for the workforce in general.

The skills situation in the formal services is better. Modern services such as ICT, telecoms, financial sector, aviation, international shipping and professional services are the largest employer of the graduates of the tertiary education system. Although there are quality differentials among supply sources of the tertiary education network, the expansion of these services is usually constrained by supply of specialized skills needed. In particular, the ICT industry is constrained by supply of skills. Public administration, education and health services are primarily dominated by the graduates of the tertiary education system, yet quality differential between various suppliers of tertiary education is substantial that reduces the value-added of these services.

In 2015-16 about 11.5 percent of the workforce (6.9 million workers) acquired skills from the higher education system and most of them are employed in formal services sector. Male graduates outnumber female graduates. Enrollment in higher education is expanding rapidly in recent years. BANEBIS (2015) data show that college enrollment (HSC and above) grew at a rapid pace of 11.6 percent between 2005 and 2015. Female enrollment has grown slightly faster than men (13 percent and 10.5 percent respectively). This is the result of both a higher rate of graduation at the secondary level and also the rapid growth of private supply of tertiary education. This is a welcome development and with continued progress this will be highly beneficial for the expansion of modern services including ICT. Nevertheless, there are substantial quality issues. Additionally, less than 10 percent of the students are enrolled in engineering, science and technology related subjects. This low concentration technical and scientific education is a serious weakness of the higher education system and tends to reduce the relevance of the higher education to market demand.

## Services Exports Challenge

The strong performance of international remittances is indicative of the success achieved by Bangladesh in exporting workers abroad, especially to the Middle East countries. This is a welcome development and benefitted from a range of government support services including remittance facilitation, government level dialogue with host countries to protect the interests of the migrant workers, tax exemption, and information sharing. There is a dedicated Ministry, the Ministry of Manpower and Labor Training, that promotes the interest of the migrant workers. Further efforts are underway to improve these services. As compared to this, the success in expanding the exports of other services is more limited.

The breakdown of services export income is shown in Table 4. The largest source of service export income is government services (47 percent). In the private sector, the four largest service exports are transport (15 percent), Telecoms and ICT (14 percent), business services (13%) and tourism (5%). The remaining 6% is comprised of a range of services including financial services. While the composition of private export earnings from services looks promising, the yields from three high-potential activities: international transport, tourism and ICT are very low.

***International Transport Services:*** In transport, the opportunity cost of weak earnings is reflected in service payments. As compared with export earnings of merely $427 million from transport services in FY2017, Bangladesh paid a huge service charge on transport from international providers to the tune of $4475 million. This yawning deficit on the transport front is a reflection of the strong dependence on foreign shipping and airlines for international passengers and freight services owing to the weak capacities and poor service quality of Bangladesh air and shipping services. The huge demand for these services from trading and passenger traffic presents a substantial investment opportunity for local investors that needs to be cashed in through proper public investments in related infrastructure (sea ports and airports, and container terminals) and facilitating regulatory policies. This effort will also create good jobs for the labor force.

#### Table 4: Other Services Exports Income ($ million)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Type of Services** | **FY2010** | **FY2011** | **FY2012** | **FY2013** | **FY2014** | **FY2017** |
| **Total other services income** | **2233.6** | **2570.2** | **2491.4** | **2827.6** | **3115.3** | **3642.2** |
| 1. Transportation | 150.6 | 191 | 336.1 | 458.7 | 460.9 | 426.8 |
| 2. Travel | 79.1 | 85.6 | 97.0 | 107.3 | 142.4 | 290.6 |
| 3. Telecommunications, computer and information services | 246.5 | 349.6 | 520.7 | 349.5 | 444.8 | 594.7 |
| 4. Other business services | 495.1 | 670 | 313.1 | 316.4 | 403.3 | 522.6 |
| 5. Government services | 1203.2 | 1192.7 | 1089.5 | 1425.6 | 1468.3 | 1539.8 |
| 6. Others n. i. e. | 59.1 | 81.3 | 135.0 | 170.1 | 195.6 | 267.7 |

***Source: Bangladesh Bank***

***Tourism:***Like the inflow of remittances, receipts from tourism can be a major source of export earnings. Importantly, it creates demand effects for a range of domestic goods and services and thereby contributes to the total employment and the GDP of the economy. Although a part of the tourism is reflected in the travel receipts in the service account of the balance of payments, the employment and GDP effects based on tourist spending on travel, hotels, food and purchases of other local goods and services are picked up in the growth of value-added and employment in transport, hotels, restaurants and trade activities. While all activities have forward and backward linkages, tourism is particularly potent source of forward and backward linkages unleashing a lot of derived demand activities. Consequently, tourism can be a major source of growth and employment in a developing economy.

According to World Tourism and Travel Council Report 2017 (WTTC, 2017a), global visitor exports accounted for 6.6 percent of total world exports (some $1.4 trillion) and an estimated 30 percent of world services exports. The global market size of tourism is indeed overwhelming. Furthermore, tourism sector grew by 3.1 percent in 2016, which is faster than total world GDP growth. The global outlook for future growth is also very bright.

Bangladesh is blessed with natural beauty, ranging from mountains to rivers to beaches to bio-diversity. It boasts the longest natural beach in the world in Cox’s Bazaar as well as the largest mangrove forest in the world at the Sundarbans. Despite this, the tourism industry is far from thriving. According to WTTC (2017b), in FY2016, tourism in Bangladesh accounted for an estimated 2.2 percent of GDP, around $5.3 billion. This is a mere drop in the bucket when compared with the world market size of $ 1.4 trillion. Accounting for indirect and induced effects, the contribution rises to 4.3 percent of GDP or $ 10.6 billion, which is still much below the world average of $55 billion and South Asian average of $42 billion.

#### Table 5: Cross Country Comparison of Tourism Performance, 2016

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Indicators** |  | **World Average** | **South Asia****Average** | **Bangladesh** | **Malaysia** | **Thailand** | **India** | **China** |
| Direct Contribution to GDP | % share | 3.1 | 3.2 | 2.2 | 4.7 | 9.2 | 3.3 | 2.5 |
| ***Rank***  |  |  | ***150*** | ***60*** | ***25*** | ***105*** | ***116*** |
| Total Contribution to GDP | % share | 10.2 | 8.9 | 4.2 | 13.7 | 20.6 | 9.6 | 9.0 |
| ***Rank***  |  |  | ***174*** | ***59*** | ***50*** | ***94*** | ***100*** |
| Direct Contribution to Employment | % share | 3.4 | 5.0 | 1.8 | 4.5 | 6.1 | 5.8 | 3.1 |
| ***Rank***  |  |  | ***163*** | ***35*** | ***46*** | ***51*** | ***110*** |
| Total Contribution to Employment | % share | 9.6 | 8.3 | 3.8 | 12.0 | 15.1 | 9.3 | 9.0 |
| ***Rank***  |  |  | ***174*** | ***68*** | ***50*** | ***94*** | ***100*** |
|  Capital Investment | % share | 4.4 | 5.4 | 1.2 | 6.5 | 7.1 | 5.7 | 2.9 |
| ***Rank***  |  |  | ***179*** | ***79*** | ***74*** | ***85*** | ***146*** |
| Contribution to Total Exports | % share | 6.6 | 6.1 | 0.4 | 8.8 | 19.2 | 5.4 | 5.3 |
| ***Rank***  |  |  | ***181*** | ***96*** | ***57*** | ***125*** | ***128*** |

***Source: WTTC 2017; WTTC 2017a.***

Table 5 provides an international comparison of the performance of Bangladesh tourism sector prepared by WTTC. Based on 6 core indicators, Bangladesh ranks at the bottom edge (150-181) for all indicators. Its performance is below the world average and the South Asian average for all indicators. Comparator countries like China, India, Thailand and Malaysia are much ahead of Bangladesh in taking advantage of its tourism industry.

The Government has pursued several policies and legislations for the tourism sector including the Bangladesh Tourism Board Act and the Tourism Policy 2010. The aim of these policies is to create a tourism friendly environment in Bangladesh, ensure quality service, and ensure comfort and safety of the visiting tourists. The Ministry of Civil Aviation and Tourism is vested with the overall coordinating responsibilities for policy formulation while implementation is the responsibility of the Bangladesh Parjatan Corporation. Several initiatives are underway during the 7th Five Year Plan to boost tourism services (Government of Bangladesh 2015). These are summarized in Table 6. The successful implementation of these initiatives during the Seventh Plan will have a significant positive impact on tourism.

#### Table 6: Ongoing Tourism Expansion Initiatives

| **Medium-Term Strategic Objectives** | **Activities** | **Implementing Departments/Agencies** |
| --- | --- | --- |
|  **Safe and secure aviation system** | Upgrading Hazrat Shahjalal International Airport | **Civil Aviation Authority** |
| Construction of Civil Aviation Authority’s Head Office |
| Development of Cox’s Bazar Airport |
| Infrastructural development of the existing airports and construction of a new international airport. |
| **Expansion of tourism** | Identifying potential tourist spots scattered over different places of the country and modernizing and expanding existing ones | **Bangladesh Parjatan Corporation** |
| Involving local government institutions in tourism activities |
| Creating infrastructure and improving management of the tourism industry through Public Private Partnership (PPP) arrangements |
| Producing documentary films on Bangladesh Tourism & publicising tourism events |
| Maintaining tourism related training courses and establishing 4 more tourist training centers |
| Participating in tourism fairs organized home and abroad and arranged related programs | **Bangladesh Tourism Board** |
| Capacity building in tourism sector |

***Source: 7th Five Year Plan***

***Export of ICT services:*** Bangladesh is a relative new comer to the ICT sector. The emphasis gained momentum in the wake of the leadership role provided by Prime Minister Sheikh Hasina through the Digital Bangladesh initiative developed in the context of Vision 2021 (Government of Bangladesh 2009). The 6th Five Year Plan (Government of Bangladesh 2011) put considerable emphasis to the implementation of the Digital Bangladesh Initiative. Considerable progress has been achieved (Government of Bangladesh, 2015). However, much of the ICT focus has been in improving the connectivity and service delivery inland within the country. The impact on export of ICT services has been relatively modest when compared with the global market prospect. As shown in Table 5, earnings from ICT exports have grown from $247 million in FY 2010 to $595 million in FY2014. This is a welcome increase but pales into insignificance when compared with ICT earnings of $105 billion in India in FY2015 (World Bank 2016). Even after allowing for size effects, India’s exports of ICT services amounts to 5 percent of GDP whereas it is less than 0.3 percent of GDP in Bangladesh. The global market for ICT services is large and India has successfully tapped this market even while expanding ICT services domestically. An important target for the services exports for the Seventh Plan will be to boost the penetration of Bangladesh into the global ICT market through a well thought out ICT strategy that looks at both domestic market and also the global market. This progress will then lay the basis for longer-term growth of ICT exports.

The past experience suggests a number of factors that constrain the growth of ICT exports. First, although a significant number of educated and qualified entrepreneurs have started ICT ventures during the last couple of decades, most are trapped in the ‘small size-low growth’ situation because of funding constraints. Second, there are severe gaps in both quantity and quality of human resources for the software industry. This is due to institutional deficiency of the tertiary ICT-related educational institutions (lack of industry orientation of teaching resources, slowness of curriculum modernization etc.) as well as inadequate quality input from the higher secondary education system to the tertiary level. Third, high cost of bandwidth deters growth of domestic market for ICT. Fourth, the absence of IT park/software Technology Park, high internet cost, no redundant submarine cable, and power shortages are some of the common infrastructural problems for most of the IT enterprises. The weakness in ICT infrastructure capabilities is well reflected by the World Economic Forum’s (WEF) Networked Readiness Index (NRI) performance that measures the capacity of the countries to leverage ICT for development (Figure 16) (WEF 2015). Finally, the growth of export of ICT industry is below the expected level due to inadequacy in entrepreneurial dynamism, limited overseas marketing budget and absence of government level initiatives in promoting country brand. Policies and facilities are not friendly for value added service providers in the mobile phone industry.

##### Figure 16: Networked Readiness Index Global Ranking 2015 (144 countries)

 **Source: World Economic Forum (2015)**

## Regulatory Policies and Support Institutions

The services sector is dominated by private business and individuals. Public ownership of services is limited primarily to public administration, public schooling, public health facilities and a limited number of public financial enterprises. So, the main driver of service output, export and employment is private enterprise and private investment. Yet, the government’s role is very important in providing the infrastructure support services, in providing the regulatory regime and in providing proper institutional support. But this was not the situation in the early years after independence when public provision of services was dominant. Through a series of deregulation drives and associated policies, the service sector was progressively deregulated and private provision encouraged. This deregulation policy has continued with recent efforts focused on encouraging private provision even in areas that are traditionally considered the domain of the public sector: education, ICT services, aviation and electricity. The response to this deregulation drive has been highly positive.

Despite good progress, there are several areas of regulatory concern that will need to be addressed moving forward. The first relates to regulatory policies for the ICT sector. The price of bandwidth needs to be reduced to facilitate increasing number of net users, enhancing demand for local content and applications and developing a connected Bangladesh. Whilst the lowest recorded price of fixed-broadband (as a percent of GNI per capita) is 0.7 per cent in case of China, it is 7.3 per cent in Bangladesh. The Rural Telecommunications Network Development and Utilization Guideline 2010 will need to be implemented to make sure that the existing network infrastructures have been optimally utilized for commercial communication and key social services (e.g. education, health care, e-governance, etc.). Another regulatory barrier that needs reform is the restriction on mobile network operators to enter mobile financial services. This restriction is without merit and has contributed to low performance of mobile financial services (Ahmed, 2017).

Another important issue is the taxation policy. The tax rates on ICT services and banking services are very high and may need to be revisited, especially to spur the expansion of ICT. For example, total taxes on ICT sector are a whopping 58 percent, which is among the highest in the world (Ahmed, 2017). This policy is also inconsistent with the Prime Minister’s Digital Bangladesh Policy.

A second set of regulatory issues that needs attention concerns quality assurance and accountability. Both these matters relate specifically to education, health and hospitality services. A huge number of education, health and hospitality enterprises have mushroomed throughout the country, but quality of service provided, safety standards of food catered to customers, cleanliness and hygienic environment and accountability of medical profession for improper diagnosis and medications have not received adequate attention. For example, the low value-added of education services is partly a reflection of low quality and inadequate regulatory standards.

A third regulatory issue concerns transport safety standards in both land and river transport. The frequency of fatal accidents for both modes of transport is far too many and cannot be considered as acceptable. As noted earlier, in addition to the issue of navigability of many river routes owing to heavy siltation, the inadequacy of safety standards of river transport has substantially lowered the demand for this important mode of transport.

A fourth regulatory issue concerns compliance with zoning laws. In the absence of proper implementation of zoning laws, the location of service enterprises have complicated urban traffic management and reduced the quality of life and safety standards of residential neighborhoods. This matter needs urgent attention and resolution through a time-bound implementation.

Regulations are helpful only to the extent that these are properly monitored and implemented. The accountability for regulations and implementations are usually assigned to concerned line Ministries overseeing the service along with a number of specialized institutions. The rapid growth in private services has not been matched by an expansion in the capacities of these ministries and agencies. Moreover, there are substantive challenges regarding training and incentive policies for public agency staff that are linked more broadly to overall public administration capacity and good governance. This is a long-term challenge that will need to be addressed holistically over a long period of time.

# THE 2041 PERSPECTIVE PLAN VISION AND OBJECTIVES FOR THE SERVICES SECTOR

The services sector played a solid role in enabling Bangladesh to secure low-middle income country status. An even stronger performance will be needed to help Bangladesh achieve high income status by FY2041. As noted, there is tremendous scope for further improvement, especially in the area of export of non-labor services, in tourism, in ICT and in modernizing trade, transport, health and education services. The FY2041 strategy seeks to consolidate past gains, builds on the lessons of past experiences in Bangladesh and in other countries and focuses on addressing the specific issues and concerns highlighted in Section C.

## 2041 Perspective Plan Vision for the Services Sector

The vision is to develop a services sector for Bangladesh that:

1) provides high quality, high value-added services in a range of activities including in finance, ICT, housing, trade, transport, health, education and public administration  such that it helps Bangladesh achieve high income status by FY2041;

2) provides the main source of high-income jobs to a growing labor force;

3) establishes a diversified NFS export base with focus on ICT, tourism, and transport;

4) develops the necessary domestic capabilities that enables the supply of adequate skills needed in manufacturing, energy and modern services with emphasis on science and technology; and

5) establishes a modern public administration that is rule based, uses modern technology, is corruption free and responsive to the needs of the citizens,

## Objectives and Targets

Consistent with the above vision, the main objectives of the service sector are:

* Increase the average labor productivity of services with special focus on trade, transport, health and education.
* Substantially increase the share of modern services in total services GDP.
* Increase the growth of NFS exports focused specifically on ICT, international transport and tourism.
* Harness the catalytic role of tourism as a growth driver.
* Improve the quality and safety of services with special focus on health, education, hospitality industry and river transport.
* Substantially enhance the quality, reliability and fairness of all public services.

Related to these core objectives, the key outputs and targets are defined in Table 7. These are achievable targets and their implementation will further strengthen the role of the services sector in the development of Bangladesh.

#### Table 7: The 2041 Perspective Plan Service Sector Targets

|  |  |  |
| --- | --- | --- |
| **Targets** | **Base Year Values (FY2017)** | **End Year Values (FY2041)** |
| Service sector growth (% per year) | 6.0 (FY2010-FY2017) | 10.6 (FY2018-FY2041) |
| Average labor productivity (TK ‘000, 2017 prices) | 449 | 2280 |
| GDP share of Services (%) | 52.7 | 60.0 |
| Share of modern services (%) | 30.3 | 80.0 |
| Employment Share of Services | 37.0 | 50.0 |
| Earnings from non-factor services ($ billions) | 3.7 | 50.0 |
| Earnings from ICT ($ billions) | 0.6 | 25.0 |
| Share of NFS in total services exports (%) | 10.0 | 15.0 |
| Direct GDP contribution of tourism (%) | 2.2 | 5.0 |
| GDP share of education | 2.5 | 5.0 |
| GDP share of healthcare | 1.8 | 4.0 |
| Public spending on education (% of GDP) | 2.2 | 5.0 |
| Public spending on healthcare (% of GDP) | 0.8 | 3.0 |
| Public spending on R&D (% of GDP) | 0.2 | 2.0 |
| Population with health insurance (%) | 0.0 | 70.0 |
| Labor force with secondary education | 31.0 | 100.0 |
| Labor force with tertiary education | 12.0 | 70.0 |
| Global ICT Networked Readiness Ranking | 109 | 50 |
| Digitized Coverage of Public Services | N/A | 100.0 |

***Source: Base year values from BBS; FY2041 values based on GED Projections***

# THE 2041 PERSPECTIVE PLAN STRATEGY FOR ENHANCING THE ROLE OF THE SERVICES SECTOR

## Services Sector Strategy

Consistent with the 2041 Perspective Plan Vision for the services sector, the strategy seeks to consolidate past gains, builds on the lessons of past experiences in Bangladesh and in other countries and focuses on addressing the specific issues and concerns highlighted in Section C. The sector strategy to translate the services sector vision into reality and achieve the related objectives and targets specified in Table 7 consists of six main elements:

* Improve the incentive policies for boosting private investment in services.
* Increase public investment in key service sector infrastructure.
* Develop capabilities that strengthen the skills base for the service industry and the industrial sector.
* Strengthen implementation of prudential regulations to boost service quality, increase public safety, improve compliance and ensure accountability of service providers.
* Strengthen public institutions to support the growth of services sector and improve service quality, safety and accountability.
* Develop a modern public administration that is consistent with the needs of a high income country.

## Incentive Policies

Learning from the positive results of the past experience in Bangladesh, the deregulation drive to motivate greater private provision of services sector activities should be strengthened. Experience with deregulation of the service industry in other emerging economies, especially India, is similarly positive. Each line Ministry concerned with regulating a particular service should undertake dialogue with concerned service providers through public meetings with business chambers and conduct special purpose surveys as necessary to obtain specific feedback on regulatory burden or other constraints. The findings of these consultations and surveys should be used to reform policies and institutions as relevant. Foreign investment in export-oriented services should be promoted, especially with a view to importing technology and thereby increasing service quality and export competitiveness. Import of technical skills in the area of aviation, international shipping, ICT and tourism should be facilitated. Wherever possible, joint venture with foreign partners should be encouraged. To encourage greater tourism, the visa requirements for visitors should be further simplified through visa on arrival facilities. Steps should also be taken to ensure the full safety and courteous treatment of all visitors.

***ICT facilitation:*** The Government recognizes that the ICT is a high potential sector. The Digital Bangladesh Initiative reflects this priority. While considerable progress has been made, the evidence presented above showed that the ICT industry is still at an early formative stage and there is tremendous scope for service expansion and industry growth. In that regard, the Government should review all ICT policies to ensure their consistency with private incentives for additional investment. Specifically, the Government should invite private sector and not-for-profit sector for rolling out broadband connectivity in rural area. Basically it might be government-private-NGO partnership for reaching the very last mile, where there is already vibrant NGO presence. Here, local entrepreneurs should be encouraged to launch last mile internet service to local community. The Government is aware that the tax policy for ICT has been raised as a major issue by the service providers. It is important to tackle this swiftly in order to facilitate additional investments from private providers and boost demand. The tax policy for ICT should be re-examined comprehensively to check for its consistency with the development objective of faster growth of this high return enterprise. The relevant international experience should be reviewed to determine proper response to this incentive issue. The competitiveness of the ICT industry is necessary to attract additional foreign investment and expand ICT services exports.

***International shipping:*** The considerable gap between payments for shipping services and income received should be addressed quickly. Bangladesh now has gained considerable shipping experiences. The merchant navy has developed considerable capacity based on the graduates of the Chittagong Marine Academy (CMA). The CMA trainees have international recognition and many graduates proceed for international training. As a result, there is a large body of trained marine staff many of whom work for international shipping firms. With adequate investments the Bangladesh shipping companies can fruitfully use this skill base to serve the shipping needs of the country’s growing merchandise foreign trade. Total merchandise trade amounted to $73 billion in FY2017. The usual shipping margin is about 10%, which yields a total shipping market of about $7.3 billion. If Bangladesh can tap even 50% of this market, earnings from shipping will grow from $0.4 billion now to $3.6 billion. The high potential of the shipping sector is obvious. To facilitate the growth of private shipping the government should immediately organize a consultation session with local and international private shipping companies to find out major obstacles and constraints to improve the shipping industry including regulatory barriers and taxation issue. Based on this, necessary reforms should be initiated to strengthen the national shipping sector.

***International and domestic aviation:*** In the area of aviation, the Government should explore the option of twining arrangements between Bangladesh Biman and a reputed international airline. A similar arrangement between Emirates and Ari Lanka was very helpful in upgrading the capability of Air Lanka. The partnership with a reputed foreign carrier will provide Biman management essential on-the-job training with how to run and manage a profitable airline industry in this globalized and highly competitive aviation world. The demand for air services, especially to London and the Middle East market, is huge and the upgrading of Biman skills and service performance will allow the capture of a larger share of this market. With good and reliable services, Biman can also attract cost-conscious international travelers visiting Bangladesh. Biman should be run as a commercial enterprise with full management flexibility. Management and staff remuneration should be market based and management should be held accountable for financial performance.

Regarding domestic aviation, the possibility of joint ventures with international partners should be encouraged. The shortage of domestic private investment is a major constraint to the expansion of domestic air services, which in turn hurts tourism prospects. Joint ventures with international partners might help relieve this constraint. The possibility of joint ventures in international shipping should also be explored. For both areas, a special study should be commissioned to highlight the constraints and identify specific reforms. The study should be conducted in the next year or so and its recommendations should be implemented following cabinet approval.

***Tourism:*** In tourism, the strategy consists of two broad elements: Expansion of fixed infrastructure to facilitate an expanded and safe aviation system in Bangladesh and second to expand and upgrade the tourism industry facilities comprising of visa and currency exchange facilities, hotels, restaurants, tourist resorts and inland transportation.

***Safe and secure aviation system:*** As noted in Table 6 above, the 7th FYP adopted a significant program to upgrade both the international and domestic aviation capacities. Timely implementation of this program will be very helpful to facilitate the proposed expansion of the tourism sector in Bangladesh. Based on the experience of the 7th FYP capacity development for aviation, a longer-term aviation plan to meet the air travel needs of a high income country should be developed with technical assistance of international aviation experts. Lessons of experience of highly successful and profitable Asian and Middle Eastern aviation giants like Singapore Airlines, Thai Airways, Emirates, Etihad and Qatar airways can provide useful insights regarding the development of the long-term aviation plan of Bangladesh.

***Tourism facilities and support services:*** Based on the lessons of good practice international experience from countries that have done well in tourism including India, Malaysia and Thailand, the strategy should focus on 5 entry points: (1) establishing at least 3 premium shopping outlets that meets international standards in the cities of Dhaka, Chittagong and Sylhet; (2) developing an eco-nature integrated resorts near Sundarbans; (3) development of a strait Riviera linking Teknaf to Sunderbans; (4) promoting the archeological sites; and (5) establishing eco parks in Chittagong and Sylhet. Additionally, there are several common enablers that can be put in place to ensure successful implementation of the above. These are:

* *Increase and focused marketing***:** Devise and ensure the right level of marketing support in the priority markets.
* *Ensure an adequate supply of qualified human capital:*Introduce measures to address issues pertaining to the supply and quality of workforce in the tourism industry.
* *Improve the tourism environment:*Improve offerings and accessibility for key tourism enablers (such as taxi services, restaurants, hotels and resorts), access to funding, security and regulations as well as improving the service quality of front-line staff.
* *Rollout of visa facilitation services:*Ensure that tourists from target markets have easy visa procedures including online 48-72 hour approvals and visa on arrival facilities.

Successful implementation of the tourism strategy will require a strong public-private partnership. The government’s role is to provide investments in fixed infrastructure (aviation), provide right incentives and enabling environment including ease of entry and exit, and ensure the safety of the tourists. Much of the investment in tourism facilities and services will have to come from the private sector. The Parjatan Corporation should work closely with Chambers of Commerce to determine how this investment promotional activity can be facilitated. Depending upon need, other incentives including credit facilities and tax incentives may be considered as relevant. Partnership with foreign investors should be encouraged.

***Housing:*** In a typical high-income country, domestic housing is a major source of GDP growth and employment. Bangladesh is way behind. The issues and challenges are well known. The Government needs to develop a thoughtful strategy for boosting the housing sector. The main elements of the strategy are to develop a strong enabling environment to facilitate both housing demand and supply.

***Demand for housing:*** The biggest constraint to a large-scale organized housing market (which is typical of all high-income countries) is the absence of a highly- competitive well-organized mortgage financing industry. In high-income economies mortgage interest rates are very low as house ownership tends to be the safest asset. Long-term low-cost housing finance upto 40 years are available from a range of housing finance companies including commercial banks. The competitive range of mortgage products availability typically enables young families to afford home ownership at low levels of income with little or even zero down-payments based on current income and credit history. Bangladesh has recently made progress with the emergence of a number of private home mortgage enterprises. But the interest cost tends to be high and qualification requirements stringent. Fiscal policies play an important role in home ownership through tax deduction of interest costs on mortgage and lower tax rates on capital gains of residential property. This is another policy that might be considered by the Government to promote home ownership.

***Supply of housing***: On the supply side the biggest constraint is the price of urban land. A host of factors has contributed to this including poor land administration and high cost of land transactions. Better land management including digitized property records and low-cost land sales and registration procedures are essential reforms to boost housing supply. The regulatory regime also needs to be simplified and properly enforced in regards to zoning restrictions, building permits and safety standards. Trade tax reduction on housing materials will also help to lower the cost of housing.

## Increase Public Investment in Related Infrastructure

The incentive policies are important for attracting private investment. At the same time, the fixed infrastructure necessary for allowing these services to grow will largely need to come from the public sector. The 7th FYP has detailed recommendations on major public investment priorities for upgrading the capacities of the service sector. Some of the medium-term priorities are:

***Transport***

* Convert all inter-district roads to 4 way lanes.
* Complete the road/bridge links to make the Asian Highway functional.
* Complete the Padma Bridge.
* Complete all ongoing flyovers in major urban centers, especially Dhaka and Chittagong.
* Complete the Dhaka circular road.
* Initiate work on Dhaka metro rail.
* Construct the Karnaphuli tunnel.
* Expand the railway capacity.
* Build the Matarbari dedicated port.
* Upgrade the effectiveness and capacity of the Mongla Port.
* Upgrade Hazrat Shahjalal international airport.
* Upgrade the Cox’s Bazar airport.
* Initiate work on the new international airport.
* Initiate dredging of major river routes.
* Upgrade river docking and storage capacities in major cities.

***Education***

* Enhance the quality of education in both primary and secondary education thorough upgrading of both physical facilities and teaching materials.
* Expand the reach of tertiary education with a special focus on women to eliminate the gender gap in tertiary education.
* Strengthen the education system capacities in Science and Technology.
* Rapidly expand ICT education at all levels
* Invest in teacher training.
* Upgrade the quality of madrasas.
* Improve quality of vocational training institutions.
* Increase R&D spending.

***Health***

* Strengthen rural health centers with focus on child and neo-natal care.
* Strengthen immunization drive.
* Upgrade and expand district tertiary public health care facilities.
* Strengthen quantity and quality of public medical staff through proper training.

***ICT***

* Build ICT parks through PPP initiative,
* Install the second submarine cable connection for expanding high speed internet facilities.
* Complete the Second Phase of implementation of broadband internet connectivity under the South Asia Sub-Regional Cooperation (SASEC) initiative.
* Expand investment in Research and Development.

***Public Administration***

* Strengthen training programs for civil servants.
* Strengthen public sector financial management.
* Modernize civil service decision making through introduction of ICT in policy and decision making, including e-procurement, e-service transactions, e-payments of wages, salaries, pensions, social security and public procurement contracts.
* Institute training programs to strengthen capacity of local government staff.

## Strengthen the Skill Base of the Service Sector

The highest priority is to adopt appropriate policies and investments to upgrade education and training quality, including emphasis on expanding tertiary education and science and technology. The ongoing policy of partnering with the private sector is sound and should continue. There is, however, a need to improve the government’s oversight on quality standards for both public and private educational institutions. The Government should also adopt a grant program to facilitate advanced research in all high-priority fields, but especially in science and technology. The Government should also facilitate e-learning and encourage partnership arrangements with international universities. A special program that has helped Japan, Korea and China to upgrade the skill base is through publicly-supported education programs in science and technology in top international universities. Bangladesh can learn from this experience and initiate a similar focused program for high-level skills that are especially scarce.

Another major policy is to substantially enhance the public spending on Research and Development (R&D). While the private sector is the main source of R&D spending at the enterprise level, innovation is mostly a public good and requires public funding. Research grants to top universities on specific areas of development interest can be a great facilitator of innovation. Linking this research to the agricultural and industrial sectors can also leverage public resources with private funding. Presently, the government spends a mere 0.15 GDP on R&D. This has to sharply go up to reach 2 percent of GDP by FY2030 and maintained at that level.

A massive effort is needed to jump-start the training sector in Bangladesh. The government adopted the National Skills Development Policy (NSDP) in 2011 with a view to upgrading the training system of Bangladesh. The NSDP broadened the training strategy to include emphasis on public-private partnership. A broad-based skill development program was adopted in 2013 with support from the Asian Development Bank (ADB 2013). Private sector training efforts have also increased, both through a range of skills-based training and through employer-financed on the job training. Yet, the progress is slow. The efforts are simply dwarfed by the scale of the skill development needs. In particular, focused initiatives are needed to upgrade the capabilities in export –oriented services like aviation, international shipping, tourism and ITC.

Much of the specialized skills in aviation, international shipping and tourism are best acquired through on-the-job training. Hence twining arrangements and joint ventures with international partners are the best ways to impart these skills. The success of the RMG industry, for example, owes a lot to these types of international partnership arrangements. The hotel industry that caters to international tourists is also benefitting from similar arrangements, but the scope for doing more is substantial. The Government should review the related regulatory policies to promote these partnership arrangements including further simplifying work permits, visa requirements, security clearances etc of international technical experts.

Regarding the ICT, special efforts are needed on a number of fronts. First is the need for expanding the breadth and depth of science and technology education in Bangladesh. The tertiary education system is still unduly biased in favor of general education. The Government should support the growth of centers of excellence in science and technology through grants and PPP initiative. Higher government spending on R&D will also support the growth of scientific education and research. Indeed, public spending on R&D is the most important driver of the growth of science and technology education and research in advanced economies. Additionally, a long term plan should be undertaken so that current supply of 5,000 yearly IT graduates can be doubled in next 2-3 years. Students from non-metropolitan cities with relatively low overseas migration trends should be encouraged to enroll. To facilitate this, colleges under national universities should be required to start IT education. Also, special education loan policy and scholarship programs should be designed to encourage students for IT education enrollment. More industry involvement will be ensured during academic programs.

## Strengthen Prudential Regulations

Prudential regulations are needed to protect consumer interest (all services), to protect depositor interests (in banking), to protect state security (internet security) and to protect citizen safety (transport, food industry, health care). In many areas, prudential regulations are in place. Nevertheless, there are important gaps in regulatory framework for many services, especially in healthcare. Most importantly, the implementation capacity is weak.

Accordingly, all regulatory authorities dealing with transport, trade, education, health, tourism and ITC should be asked to look at the adequacy and relevance of all concerned regulatory issues, both prudential and enabling, with a view to upgrading and modernizing the regulatory framework for services sector. The objective of this review will be to facilitate private investment while protecting genuine consumer and state interests. Proper consultation with stakeholders should be done to ensure correct diagnostics for reform. Lessons of international experience should also be reviewed as necessary

In the area of prudential regulations, the emphasis should be on the following core aspects:

* Accreditation policies to ensure minimum quality standards in education.
* Licensing of health practitioners and private hospitals/clinics/labs to ensure health safety and acceptable standards.
* Ensure accountability of healthcare professionals by establishing a grievance unit under the Ministry of Health that looks at public complaints for poor services.
* Licensing of food vendors in hotels, restaurants and other commercial food vendors to ensure sanitation and health safety standards.
* Strict monitoring of licensing and driving records of truck and bus drivers.
* Monitoring of road damage based on vehicle weight and loading norms.
* Strict implementation of safety features of commercial vehicles
* Strict inspection of all river vessels and monitoring of vessel loads.
* Require purchase of liability insurance for all healthcare providers and enterprises engaged in the transport industry.
* Enforcement of proper zoning laws for all commercial enterprises and strict implementation of parking regulations for all vehicles.

The implementation of these regulations will require proper education through mass media as well as cooperation with the private enterprises. To minimize the administrative burden on public institutions, a system of financial penalty and revoking of licensing where deemed necessary should be instituted to provide an incentive for self-regulation. Implementation should be done through spot check. To ensure that the regulations are not used by public agency staff to harass the enterprise or increase the cost of doing business, all licensing requirements should be administered online with established timelines for responses. An online complaint registry should be established to redress enterprise grievances. Staff of public regulatory agencies should be enhanced as necessary and should be given necessary training. Strict disciplinary actions should be enforced for public service agents that are found in violation of ethical and service standards.

## Strengthen Public Institutions

The challenge of strengthening public institutions is pervasive in Bangladesh (Ahmed, Alamgir and Mujeri, 2016). But this challenge is most intensive in the public services sector, especially those public sector institutions that provide direct services to the citizens. These include health, education, transport and agriculture. Some public sector agencies provide only regulatory and policy support to private sector. These include the Ministry of Finance, the Bangladesh Bank, the Ministry of Commerce, and the Ministry of Land Administration. But there are many that provide both services. Together, these agencies are a part of public administration. Hence, a broad-based reform of public administration is key to Bangladesh achieving higher income status. Of particular importance is the need to ensure the efficiency and effectiveness of the regulatory agencies dealing with services that are subject to global competition. They require special skills and capacities. These include: the Civil Aviation Authority, the Ministry of Shipping, the Bangladesh Telecommunications Regulatory Commission (BTRC) and the Parjatan Corporation (Tourism Board). The capacity and effectiveness of each of these regulatory agencies is critical to increase the international competitiveness of related services.

The reform of public administration is a long-term endeavour. It is complex, politically sensitive and time consuming. So, a pragmatic reform strategy is needed. One possible approach is to start incrementally focusing on areas that are not very controversial and adopt a phased approach for the more complex institutional reforms. Three broad-based initiatives that can yield considerable long-term benefits are: digitization of public administration; public financial management reforms and a comprehensive training strategy for public administration staff. The digitization could be of especial benefit to tackle corruption problems upfront. Adoption of e-procurement, e-payments, and e-service delivery can be instrumental in improving the accountability of public administration and reducing corruption. The Government has already initiated reforms and adopted specific programs in each of these areas but progress is slow. For each of these three areas, a time-bound action plan with monitorable indicators of progress should be adopted. Progress should be monitored at the cabinet level with each line Minister and Secretary responsible for implementation.

In terms of basic service delivery, a key reform is the devolution of health and education services to the local governments. This is admittedly a politically sensitive and contentious reform; but its implementation is essential if Bangladesh is to aspire to achieve high-income status by FY2041. The process needs to start now as implementation will take time. The devolution will need to be broadly defined to include: reform of the legal framework that clearly delineates the responsibilities by levels of government, avoids contentious overlaps of responsibilities and accountabilities; fiscal decentralization that enables appropriate sharing of public revenues in line with devolved responsibilities; capacity building and training; and a framework of accountability for performance. There are ample international experiences that Bangladesh can learn from in developing its devolution strategy. An example of holistic reform of urban governance is contained in Ahmed, Ahmad and Mahmud (2007).

A second important service sector institutional reform is the reform of public banks. These banks are a drag on the economy and eat up scarce public resources. The status quo is not sustainable and the reforms must be adopted immediately to stop the bleeding of the banking sector resources and build up its health. The suggested reform is to privatize all public banks except the Sonali Bank that can be retained to perform various Treasury functions. The Sonali Bank will take deposits but use them only to finance the Treasury via holding of highly secure T-Bills. If the public banks cannot be privatized in the near future on political grounds, they should be at least fully commercialized under private management and required to earn profits. They should be fully supervised by the Bangladesh Bank with full compliance of prudential standards. No government involvement in loan transactions or restructuring should be allowed. Senior management and Board selection should be vetted by the Bangladesh Bank as per set guidelines of fit and proper.

# INVESTMENT REQUIREMENTS FOR THE SERVICE SECTOR

Much of the investment in services sector will come from the private sector. The improvements in regulatory and incentive policies will spur the expansion of private domestic and foreign investment. Yet, complementary public investments in fixed infrastructure will be a critical determinant for expansion of private investment, valued added, employment and exports of services.

To secure the modernization of the services sector both public and private investment will need to go up as a share of GDP. In the indicative projections, total investment requirements in services will go up from 13.8 percent of GDP in the base year (FY2017) to 16.0 percent of GDP in FY2031 and is maintained at that level until FY2041. Public investment increases from 3.4 percent of GDP in FY2017 to 4.0 percent in FY2021 and FY2041, whereas private investment moves up from 10.4 percent of GDP in FY2017 to 12.0 percent of GDP in FY2031 and FY2041. Most of the public investment will be in physical infrastructure and facilities related to transport, ICT, education, health facilities and public administration. Private investment on its part will focus on providing direct services in health, education, tourism, ICT, shipping, aviation and a range of other services. Along with reforms of regulations and incentives for private investments, these complimentary public investments will be necessary to spur the expansion of the private investment in direct service provision.

#### Table 8: Investment Requirements of the Service Sector (taka billion 2017 prices)

|  |  |  |  |
| --- | --- | --- | --- |
|  | **FY2017** | **FY2031** | **FY2041** |
| Public  | 677 | 2771 | 7732 |
| Private | 2025 | 8313 | 23197 |
| Total  | 2702 | 11084 | 30929 |
| Public (% of GDP) | 3.4 | 4.0 | 4.0 |
| Private (% of GDP) | 10.4 | 12.0 | 12.0 |
| Total (% of GDP) | 13.8 | 16.0 | 16.0 |

***Source: GED Projections***

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1. A detailed analysis of the services revolution in South Asia is contained in Ghani (2010). [↑](#footnote-ref-1)
2. The Harris-Todaro model (1970) recognized the role of informal services in the transition from agriculture to manufacturing. Even so, this was a short-term temporary phenomenon. In Bangladesh, the services sector has blossomed and provided growth leadership for a fairly long period. [↑](#footnote-ref-2)