

Political Economy of Trade Policy: Theory and Evidence from Bangladesh

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Zaidi Sattar¹
Ashikur Rahman²

Abstract

Trade policy within Bangladesh has followed a course of gradual liberalization associated with tariff reduction and rationalization, and removal of protective quantitative restrictions. But the pace of liberalization has varied significantly over different periods depending on the state of the economy or the weight of influence of different actors. To capture this dynamics, in this article, we develop a simple decision theory model to understand how an incumbent government decides upon tariff rationalization strategies. In particular, the role of key stakeholders—consumers, exporters and import substituting industries—is considered, and the collective action issues faced by each group are examined to understand how incumbent governments will respond to their relative influence. Two principle inferences are drawn from this analysis. First, incumbent governments are more likely to facilitate tariff rationalization episodes in times of economic or political crisis. Second, if the economy is not in a state of crisis and consumers suffer from the acutest form of collective action problem, then one can expect that tariff rationalization momentum will be slow or non-existent as long as import substituting industries have equal or more policy clout than exporters. These inferences are then examined in the context of trade policy developments in Bangladesh.

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Keywords

Trade, tariff, liberalization, tariff rationalization, economic or political crisis

¹ Chairman, Policy Research Institute (PRI), Dhaka, Bangladesh.

² Senior Economist, Policy Research Institute (PRI), Dhaka, Bangladesh.

Corresponding author:

Zaidi Sattar, Chairman, Policy Research Institute of Bangladesh, House #16, Road 10A, Block H, Banani, 1213 Bangladesh.

E-mail: zaidisattar@gmail.com

Introduction

While conventional economic doctrine has been a vibrant advocate of free trade, political actors in developing countries have been relatively less receptive of the idea. This compelled economists and political scientists to accept that the possible sources of trade restrictions are political, and one needs a better understanding of the interplay between political actors and relevant stakeholders to shed insights into the dynamics surrounding trade restrictive policy regimes (Nelson, 1988; Rodrik, 1995). In addition, even though there exists a near-universal view among mainstream economists on the desirability of free trade¹, it is still not clear what *triggers* trade liberalization episodes between certain time intervals and why such a process often stalls. Is it an idiosyncratic outcome of a policy-making process? Or, is it a strategic response of an incumbent government to an economic or political scenario? We search for answers by reviewing the scenario in Bangladesh.

Table 1 shows that in the post-1990 period, a comprehensive trade liberalization initiative was launched in Bangladesh, which meant that the average protective tariffs were reduced significantly—with a marked reduction in top custom duties from 160 per cent in FY92 to 25 per cent in FY05. But, the tariff rationalization momentum was interrupted by episodes of reversal in the late 1990s (Sattar & Devarajan, 2009), and in recent times (Sattar, 2014), thanks to the emergence of protection-induced para-tariffs.

This article looks into the dynamics of trade liberalization episodes. In particular, we develop a simple political economy model that aims to explain the prevalence of trade restrictions, with a specific focus on economic climate during which policies are chosen and collective action issues faced by each interest group in the model. The purpose here is to isolate the political economy consideration behind ‘tariff rationalization’ and discuss the conditions that shape the optimal strategies for the policymaker. The model, supported by descriptive evidence, then helps to explain: Why trade restrictions prevail and why certain groups often find themselves ‘unaccounted for’ in trade policy deliberations? Thus, this research provides some useful political economy insights into these questions. The employed model is intuitively similar to the ‘influence driven’ approach developed by Grossman and Helpman (1994) which cites special interest group as a main reason for ‘protection’ to prevail in economies.² On a broader note, this article contributes

Table 1. Progress in Tariff Rationalization

	FY92	FY96	FY00	FY05	FY10	FY12	FY13	FY14	FY15
Average CD (unweighted)	70.64	28.7	22.4	16.31	13.67	13.57	13.87	13.19	13.17
Average NPR	73.32	31.65	29.09	26.52	23.88	26.96	28.93	28.09	26.88
Top CD rate	160	50	37.5	25	25	25	25	25	25
Tariff slabs	18	8	5	4	5	5	5	5	5

Source: National Bureau Revenue database and Policy Research Institute estimates.

Note: CD = customs duty; NPR = Nominal protection rate, FY = Financial year.

to the larger body of work that examines the role of interest group, foreign interests and governments in influencing policies geared towards trade protection (Grossman & Helpman, 1995; Hillman & Ursprung, 1988).³ This article also contributes to the growing literature on trade liberalization in Bangladesh (Ahmed & Sattar, 2004; Rahman, 1994; Taslim, 2004; Yilmaz & Varma, 1994).

In the following section, we discuss the model and the principal propositions derived from it. The next section ‘Evaluation of the Propositions: Evidence from Bangladesh’ examines the proposition by evaluating some descriptive evidence from Bangladesh. The principle aim here is to investigate what triggered ‘tariff rationalization’ effort, and what factors shaped its evolution. Last section provides the concluding remarks.

The Model

Model and Some Propositions

Political economy models where political considerations shape tariff rationalization decisions have emerged as a natural medium for understanding the evolution of trade policies. The aim of the present model is to evaluate the conditions that are likely to determine the payoffs from a set of strategies that an incumbent government faces while interacting with the key stakeholders in the economy. The institutional framework under which the relevant actors interact are assumed to be democratic (i.e., policymakers face re-election). Furthermore, the model is intuitively similar to the influence-driven approach which views trade policy as an outcome of the relative influence of various interest groups. The incumbent government (G) is assumed to be driven by self-interest. This means that it has two key motivations, which are as follows:

- seek re-election after completing its existing tenure,
- maximize campaign contribution for the party and concessional aid for the budget.

Other groups in the model include: consumers (C), exporters (E) and import substitution industries (ISIs), who offer political campaign contribution if their interests are protected/served by the incumbent government. There is also a donor (D) from whom the government seeks aid δ . This model proposes a two-period decision theory where an incumbent government (G) decides in the first period whether or not to facilitate tariff rationalization for receiving aid δ from donor (D). This means it can choose from two tariff level $T \in \{L, H\}$, where $T = H$ corresponds to a high tariff regime and $T = L$ corresponds to low tariff regime. There is also a conditionality—{P} indicating lowering tariff—that the government has to accept for receiving the donor support $\delta > 0$, where $\delta \in \{0, 1\}$. Additionally, the value of the donor support δ to the government’s pay off function is dependent on the policy climate K during which aid is received. In other words, when the government is facing a state of crisis, then $K = 1$. Conversely, if the government

is not facing a state of crisis, then $K = 0$. Thus, $K \in \{0, 1\}$. Likewise, by crisis we refer to a situation when the government is experiencing one of the following scenarios: low foreign reserve, economic recession and high political turmoil, since they are likely to increase the value of aid to an incumbent government. Moreover, we assume that without availing conditionality-tied foreign aid during a time of crisis, an incumbent will have zero probability of winning a re-election. We also assume that conditionality-tied foreign aid has no relevance on its own during the non-crisis time interval.

In the second period, exporters, ISIs and consumers determine the level of the political campaign contribution they are going to offer to the incumbent government when it seeks re-election after observing how the government facilitated their interest. Hence, the following campaign contribution conditions exist.

- Exporters offer a campaign contribution $\alpha > 0$ (where $0 \leq \alpha \leq 1$) if they observe that government in the first period has lowered tariff levels (i.e., $T = L$). In any other case, where tariff levels remain high, they offer a campaign contribution $\alpha = 0$.
- ISIs offer campaign contribution $\beta > 0$ (where $0 \leq \beta \leq 1$) if the government in the first period did not lower tariff (i.e., $T = H$). In any other case, they offer campaign contribution $\beta = 0$.
- Consumers offer campaign contribution $\gamma > 0$ (where $0 \leq \gamma \leq 1$) if they observe that the government in the first period has lowered tariff levels (i.e., $T = L$). Otherwise, they offer contribution $\gamma = 0$.

Given the cumulative campaign contribution from all actors cannot exceed the total political contribution that is available in a polity, the following condition must hold:

$$\alpha + \beta + \gamma \leq 1.$$

Furthermore, given each group—exporters, ISIs and consumers—comprises multiple actors, they are likely to face different collective action constraints in ensuring they can commit to their stated campaign contribution. This allows us to state that the likelihood for each group to be successful in mitigating their collective action problems is summarized by the following conditions.

- There is probability p (where $p \in [0,1]$) that exporters are able to commit to their campaign contribution function.
- There is probability q (where $q \in [0,1]$) that ISIs are able to commit to their campaign contribution function.
- There is probability r (where $r \in [0,1]$) that consumers are able to commit to their campaign contribution function.

Thus, the payoff function of an incumbent government is

$$P_G(\alpha, \beta, \gamma, \delta) = (p.\alpha + q.\beta + r.\gamma) + K.\delta.$$

Table 2. Strategies Available to an Incumbent Government

Strategy-1	Government refuses to lower tariff: $T = H$. This means it receives $\delta = 0$ from the donors.
Strategy-2	Government lowers tariff ($T = L$) and it receives $\delta = 1$ from the donors.

This means that the payoff function of the incumbent government increases with the level of the cumulative campaign contribution it receives and the likelihood that each group will be able to commit to its campaign contribution function. The employed function is also indicative that donor support δ is only relevant when the government is facing a state of crisis ($K = 1$). So, the following strategies are available to the government (see Table 2).

Furthermore, this model allows us to make two general propositions:

First Proposition: If the government is not in a state of crisis, then the government will not opt for tariff rationalization as long as

$$q \cdot \beta \geq p \cdot \alpha + r \cdot \gamma.$$

In other words, as long as the strength of ISIs to provide campaign contribution and mitigate its collective action problem *outweighs* the strength of exporters and consumers to provide the campaign contribution and mitigate their respective collective action problem, government will not opt for tariff rationalization during non-crisis time intervals.

Second Proposition: If the government is in a state of crisis, then the government will opt for tariff rationalization as long as

$$q \cdot \beta \leq p \cdot \alpha + r \cdot \gamma + 1.$$

This condition implies that as long as exporters or consumers have some capacity to offer campaign contribution (i.e., $\max(\beta) < 1$), during a state of crisis an incumbent government will always opt for tariff rationalization and receive conditionality-tied foreign aid.

In the following sub-section, we briefly discuss some insights from the literature on the collective action problem to understand the relative magnitude of: p , q and r .

Insights from Collective Action Problem

In 1965, Mancur Olson produced his intellectual Magna Carta, *The Logic of Collective Action*, which examined the calculus of an individual's decision-making process while pursuing a collective good for a group. Prior to Olson, social scientists had a natural tendency to assume that individuals with common interest will act collectively to achieve those interests. Olson, however, argued otherwise. He stated that any theory of group behaviour must depend upon the incentives faced by each individual in the group, and not simply assume that

groups can pursue their common goal without any difficulty. More importantly, he argued that if a group is lobbying for a public good that is non-excludable⁴ in nature, then the benefits of the good cannot be withheld from the non-participants in the group's collective action. This motivates rational actors in the group to free ride, since the net benefit of availing the benefit of the good by non-participating is higher in comparison to availing the benefit of the good by participating. Thus, participation in a collective action is viewed as an 'irrational' outcome and it highlights a classic case when group rationality contradicts individual rationality. Additionally, this framework allows Olson (1965) to make a key proposition: collective actions are likely to fail when group size is large.⁵ Thus, with this basic insight, we suggest the following conditions.

- The probability that ISIs will be able to commit to their campaign contribution is larger than that of consumers as the latter constitutes a much larger group size: $q \geq r$.
- The probability that exporters will be able to commit to their campaign contribution is larger than that of consumers as the latter constitutes a much larger group size: $p \geq r$.
- The probability that consumers will be able to commit to their campaign contribution is very small: r is likely to be close to 0.

In the following section, we evaluate the two propositions that are derived from our model.

Evaluation of the Propositions: Evidence from Bangladesh

Primary Inferences

This article employs a simple model to understand the dynamics surrounding the evolution of trade policy. Additionally, it allows us to evaluate two key inferences which one can derive from the following deduced propositions.

1. *First Inference:* The model proposes that if the government is in a 'state of crisis', then irrespective of the relative political strength of each group⁶ and the collective action problem they face, the government is going to lower tariff to receive donor support. Hence, 'crisis time intervals' are more likely to witness tariff rationalization response for donor support in comparison to 'non-crisis time intervals'.
2. *Second Inference:* The model proposes that if the government is not in a state of crisis and consumers who benefit from tariff rationalization suffer from the acutest form of collective action problem, then one can expect that tariff rationalization momentum will be slow or non-existent in 'non-crisis time intervals' as long as the strength of ISIs to provide campaign contribution and mitigate its collective action problem *outweighs* the strength of exporters and consumers to provide campaign contribution and mitigate their respective collective action problem. More formally, if consumers have

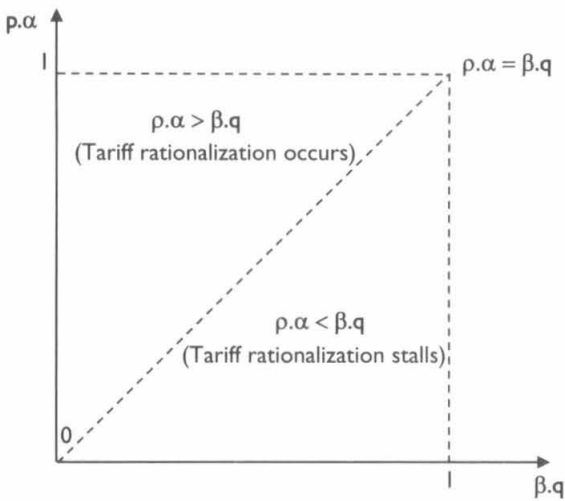


Figure 1. Decision Space

Source: Authors' formulation.

acute collective action problem (such that $r = 0$), then during non-crisis time intervals, tariff rationalization will depend on the relative collective action strength and campaign contribution capacity of ISIs and exporters. In other words, if $\beta \cdot q \geq \alpha \cdot p$, then the incumbent government will keep tariff high. However, if $\beta \cdot q \leq \alpha \cdot p$, then the incumbent government will opt for tariff rationalization. Figure 1 details out the decision space in this context.

Intuitively, these propositions bear some resemblance to Grossman and Helpman (1994) and Grossman and Helpman (1995), which view trade policy choice as a product of influence of interest group, foreign interest and electorate who jointly determine the payoffs of an incumbent government. However, while Grossman and Helpman (1994) assume the presence of organized groups, our model explores how equilibrium strategy of an incumbent depends on the relative collective action strength of each group in the polity and the economic and political climate within which the decisions are made. In this context, it bears some resemblance to Mitra (1999), which offered some attention to the process of lobby formation and how that ultimately shapes trade policy choices.

The preceding propositions are examined in the following sub-section in the context of the trade policy evolution in Bangladesh.

Evidence from Bangladesh

In this section, we evaluate the trade policy evolution of Bangladesh in light of the key inferences discussed earlier. This is done in three steps. First, we check if the assumption—donors provide support with conditionality that the incumbent government must lower tariff—is supported by the evidence from Bangladesh. In fact, if we review the 13 Import Program Credits (IPCs) that Bangladesh received

between 1972 and 1986, and the loans it received under various Structural Adjustment Programs of the World Bank and IMF during 1986/87 and 1990/91, it can be seen that donor support during the mid and late 1980s and 1990s carried significant conditionalities (Bhattacharya & Titumir, 1998).⁷ These conditionalities aimed at the following.

- Deregulation of investment.
- Elimination of quantitative restrictions on imports except for those required for reasons of religion, health, security and social considerations and a small number of highly sensitive items.
- Rationalization of the tariff structure and reduction of maximum tariff levels.
- Removal of export subsidies.

Consequently, it is pragmatic to argue that the assumption of donors providing support with conditionalities to facilitate tariff rationalization mostly holds when we review the major 'donor-government' interaction in Bangladesh in the late 1970s, 1980s and early 1990s.

Second, we scrutinize, in the following section, the trends of various economic and political variables to isolate 'crisis time intervals' and 'non-crisis time intervals' so that we can pinpoint whether tariff rationalization occurred during (or immediately follow) a state of crisis or not. It is important to clarify, however, that the present scrutiny does not attempt to rigorously establish a causal link between 'crisis time intervals' and tariff rationalization episodes. Rather, the aim here is to see if the two distinct phenomena coexisted within the noted crisis time intervals, so that we can verify whether or not we have any prima facie evidence in support of the first key inference. Third, we explore how collective action problems are likely to vary among the key actors in Bangladesh and see whether or not the second key inference finds any validation.

First Inference and Evidence from Bangladesh

One of the key inferences that we have derived from the mentioned propositions is that if the government is in a 'state of crisis', then irrespective of the relative political strength of each group and the collective action problem they face, the government is going to lower tariff to receive donor support. As a result, 'crisis time intervals' are more likely to experience tariff rationalization initiatives in response for donor support in comparison to 'non-crisis time intervals'. Hence, we explore three types of crisis:⁸ balance of payment crisis, growth crisis and political crisis.

Balance of Payment Crisis

A 'Balance of Payment Crisis generally refers to an economic phenomenon when a country is unable to mobilize foreign reserve to pay for essential imports and/or service its debt repayment. In Bangladesh, just after the independence, when the country was suffering from a war ravaged economy, rising import bills (due to the

import of petroleum and petroleum products) and low levels of export caused the reduction of foreign reserve from approximate US\$ 270 million in FY1973 to US\$ 143 million. Additionally, if we examine Figures 2–4, we can see that the economy also experienced significant fall in foreign reserves between FY1982 and FY1983, FY1990 and FY1991, and a gradual fall between FY1996 and FY2001. Even between FY2011 and FY2012 foreign reserve reduced by nearly US\$ 1 billion.

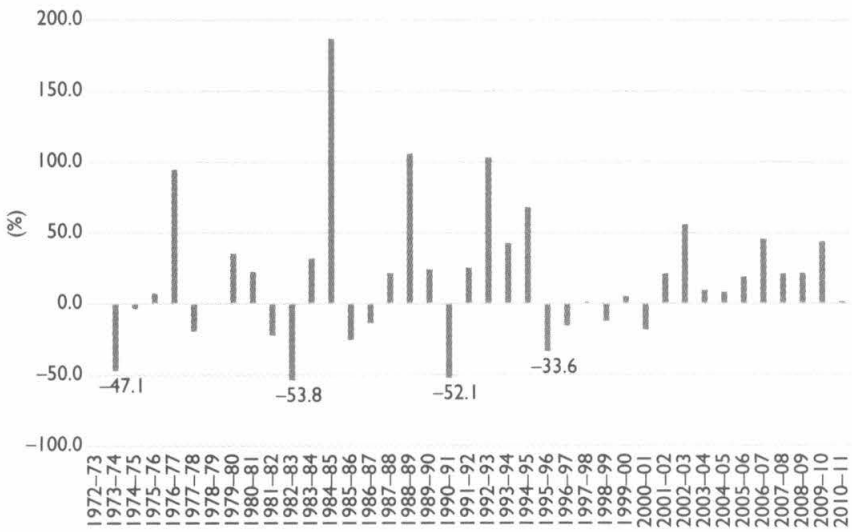


Figure 2. Growth of Foreign Reserve

Source: Bangladesh Bank Data Base.

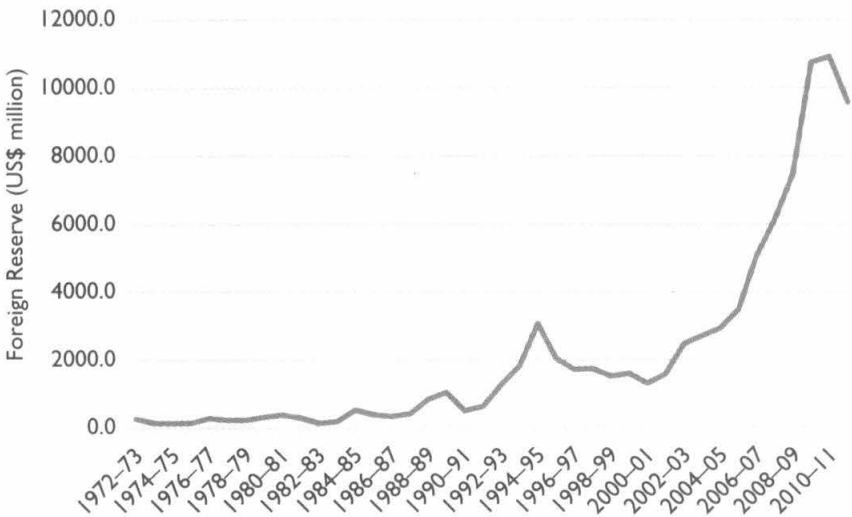


Figure 3. Foreign Reserve

Source: Bangladesh Bank Data Base.

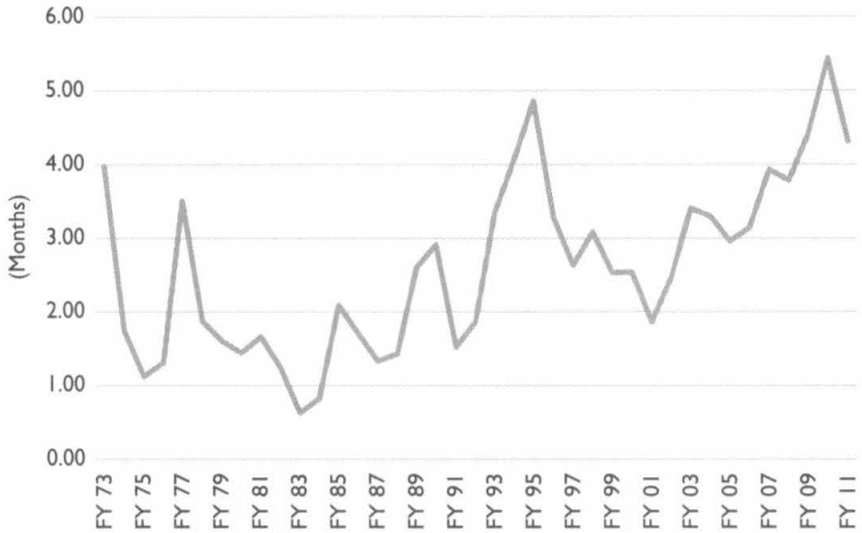


Figure 4. Reserve to Cover Import Demands

Source: Bangladesh Bank Data Base.

Moreover, in the context of Bangladesh, it can be pragmatically stated that the comfort zone for foreign exchange reserve is a level that covers over four months of import bills. However, any foreign exchange reserve failing to maintain two months of import bill is surely alarming. Besides, if we review Figure 4, it can be deduced that throughout 1970s, Bangladesh's foreign exchange reserve sputtered around US\$ 200 million dollars covering barely two months of import bills. Nevertheless, in 1973–1974, even maintaining that basic level of foreign exchange reserve became a challenge giving rise to the first BOP crisis. The second crisis came in 1983–1984, when foreign exchange reserves fell by almost 54 per cent in the previous year, constraining policymaker's capacity to maintain even one month of import bill. Finally, in 1990–1991, came another sharp decline in foreign exchange reserve of more than 50 per cent, leaving the reserve situation in tatters with barely one month of import coverage available. This BOP development also prompted and deserved immediate attention, culminating in the World Bank—IMF structural adjustment facilities—ISAC-II and ESAF (IMF). Accordingly, if the insights from Figures 2 to 4 are considered simultaneously, three specific time intervals can be categorized as 'BOP Crisis Time Interval', which are FY1973–1974, FY1983–1984 and FY1991–1992.

Growth Crisis

If we review the economic growth experience of Bangladesh, it is evident from Figure 5 that the economy suffered acute contraction in FY1971 and FY1975. This was the resultant effect of a war ravaged economy that policymakers inherited in 1972. On the other hand, post-1976 the economy generated a positive growth rate, even though the pace of acceleration was comparatively lower in 1980s in comparison to the growth rate in 1990s and 2000s. Likewise, in 1990–1991, a

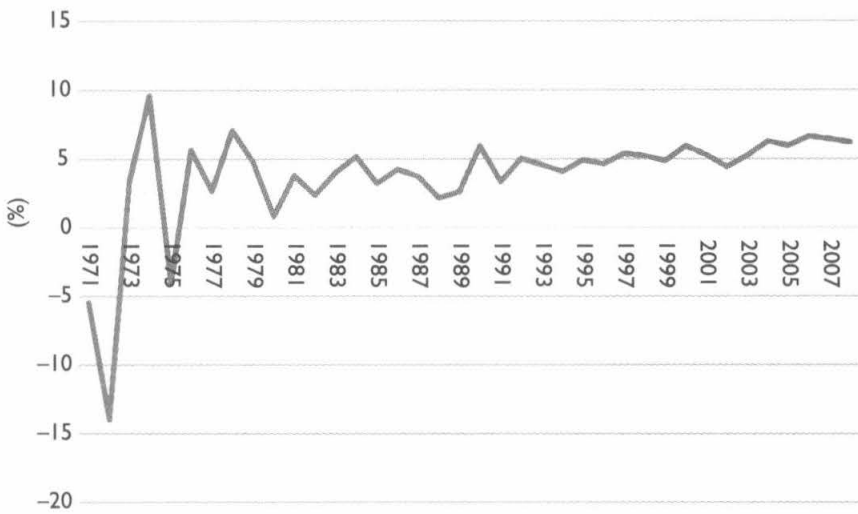


Figure 5. GDP Growth

Source: World Bank Data Base.

political crisis that led to the removal of a decade old authoritarian regime also experienced a confluence of BOP and growth crisis, as GDP growth plummeted to 3.3 per cent from a 5.9 per cent high in FY1990. Therefore, we can classify three different time spans as ‘growth crisis time intervals’, which are FY1971, FY1975 and FY1991.

Political Crisis

A state of political crisis often allows external actors to find leverage within the domestic policy space (IGS, 2011). The political landscape of Bangladesh has been a hotbed of political turmoil since its independence in 1971 and confrontational mindset between the two key political parties has been often identified as a key factor undermining its political stability (CGS, 2006; IGS, 2008). This, to an extent is depicted in Figure 6, which shows the evolution of our political transition by mapping Polity Score for Bangladesh across time, which is taken from Marshall and Jaggers (2009) and it quantifies the degree of democracy entertained within political arenas of various countries. The POLITY variable has 21 categories, ranging from -10 to +10, where -10 reflects extreme autocracies. Thus, whenever we witness an extreme switch from a negative score to a positive score (or from a positive score to a negative score) we can state that country has witnessed a major political crisis. So Figure 6 points out three crucial time intervals which correspond to these criteria.

- **FY1975:** Violent coup d’état that introduced military rule in a newly independent nation.
- **FY1991:** Fall of the military regime after the mass uprising in 1990 which revived the democratic format of governance.

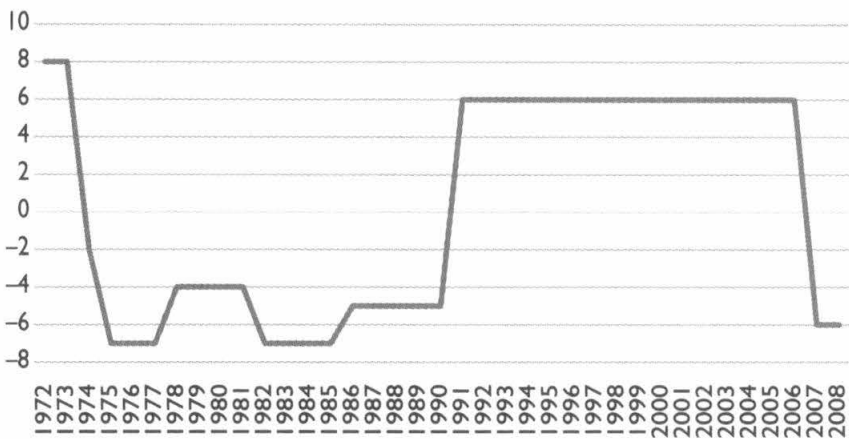


Figure 6. Polity Score for Bangladesh

Source: Polity IV Data Set.

- **FY2007:** State of emergency was declared on the 11th of January after Awami League led Grand Alliance boycotted the scheduled 9th Parliamentary elections in January 2007.

As a result, if the information in Figure 6 is taken into consideration, then we can identify the following time spans as ‘political crisis time intervals’: FY1975, FY1991, FY2007.

Overall ‘State of Crisis’ and ‘Tariff Rationalization’ Episodes

As noted earlier, the first key inference is suggestive that if the government is in a ‘state of crisis’, then irrespective of the relative strength of each group and the collective action problem they face, the government is going to rationalize tariff to receive donor support. Hence, we scrutinize all such crisis time intervals simultaneously to point out time spans which we can categorize as ‘overall state of crisis’. In Table 3, all crisis intervals are arranged across the columns. Furthermore, it can be seen that between FY1973 and FY1976, Bangladesh faced severe BOP, growth and political crisis. This to some degree is an outcome of war that led to Bangladesh’s independence and the political feud between various groups that immediately followed (Karim, 2005). The economy also faced a serious BOP crisis between FY1983 and FY1984, when reserves reduced by almost 54 percentage point, which constrained our capacity to maintain even one month of expected import bill. The time interval FY1990–FY1992 is also interesting because the economy witnessed significant fall in foreign reserve and the political climate experienced intense turmoil due to mass movement in the late 1990s which facilitated the inception of democracy. Thus, Table 3 allows us to identify three key ‘overall crisis time intervals’, which are FY1973–FY1976, FY1983–FY1984 and FY1990–FY1992.

Table 3. Three Types of Crisis Time Intervals

BOP Crisis	Growth Crisis	Political Crisis
FY1973–FY1974	FY1971–FY1972; FY 1975	FY1974
FY1983–FY1984		
FY1991–FY1992	FY1991	FY1991 FY2007
Overall Crisis Time Intervals		
FY1974–FY1976		
FY1983–FY1984		
FY1990–FY1992		

Source: Authors' formulation.

Furthermore, given the first inference indicates that tariff rationalization is more likely to occur during (or immediately follow) crisis time intervals, we can now relate tariff rationalization episodes with crisis time intervals. Crisis period in the 1970s and 1980s were followed by the government accepting donor conditionalities under various import programs, which had only modest requirement of import liberalization. The first major tariff rationalization episode came with the political, BOP and growth crisis of 1990–91. It came as a part of a broad-based structural reform program that included trade liberalization and investment deregulation as core reform areas. It is worth noting that despite episodes of BOP crisis, not much tariff rationalization occurred until 1990, since average and top tariff rates were high and prohibitive (some 40 per cent of tariff lines had tariff rates of 100 per cent above in 1990). Substantial reduction and rationalization⁹ of tariff occurred from FY1992 onwards under the ISAC/ESAF program conditionalities negotiated by the World Bank and IMF, respectively (see Table 5). Hence, the overall analysis is suggestive that policymakers in early 1990s promoted trade liberalization to earn donor support, given the economy was under significant pressure due to a looming BOP, political and growth crisis in FY1991.

Additionally, even if we review trade liberalizing activities following FY1985, it is observed that number of items in the control list at the HS 4-digit level reduced by nearly 30 per cent. This also followed the severe BOP crisis that Bangladesh experienced between FY1983 and FY1984. More precisely, the BOP crisis during the mentioned time interval was particularly severe since policymakers even struggled to maintain foreign reserve sufficient to meet barely one month of import bills. Now, due the lack of availability of tariff data before 1990, we cannot examine its trend to see whether tariff rates dropped post FY1984. As a result, we acknowledge the strength of the first key inference (in this case) with some degree of caution. Similarly, due to non-availability of data, we could not study how trade liberalization evolved between FY1972 and FY1985, when Bangladesh received 13 IPCs (worth more than 1 billion US\$) during that mentioned time interval.

On the whole, the evidence from Bangladesh does provide some informal support to the notion that trade liberalization is more likely to occur or immediately follow crisis time intervals if the donors utilize this opportunity to bargain with

Table 4. Evolution of Import Restrictions 1985–2012

	IPO 1985	IPO 1987	IPO 1989–91	IPO 1991–93	IPO 1993–95	IPO 1995–97	IPO 1997–02	IPO 2003–06 <i>July 2003</i>	IPO 2003–06, <i>Jul05</i>	IPO 2006–09, <i>Jun07</i>	IPO 2009–12
Number of items in the control list at the HS 4-digit level	478	315 (26.1%)	320 (25.8%)	193 (15.6%)	111 (9.0%)	120 (9.7%)	122 (9.8%)	67 (7.3%)	25(chk) (2.0%)	26 (2.1%)	
Number of trade- related items in the control list at the HS 4-digit level	n.a.	253 (21.1)	n.a.	79 (6.4%)	19 (1.5%)	27 (2.2%)	28 (2.2%)	19 (1.9%)	5 (0.3%)	2 (0.2%)	3 (0.2%)

Source: Ministry of Commerce Data Base

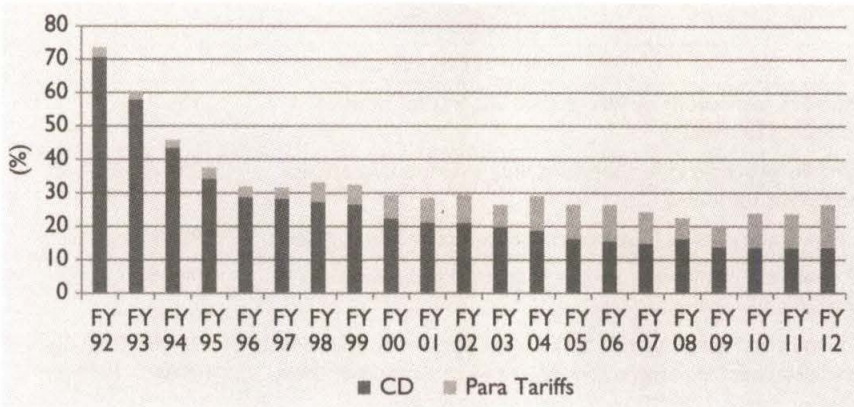


Figure 7. Unweighted Average Protective Tariffs in Bangladesh during FY1992–FY2012

Source: Policy Research Institute Data Base.

Table 5. Summary of Structural Adjustment Policies

Trade and Industrial Policy	
Tariff Reform	
Rationalize import regime.	Ongoing
Reduce and narrow the band of net effective level of protection for textiles and steel on the basis of TIP study.	1986/87–1988/89
Reduce level and rationalize structure of tariffs in the textile, steel and engineering, chemical and electronics industries.	1987/88 onward
Reduce maximum custom duties to 20% for raw materials, 75% for intermediate goods and 100% for finished goods.	1987/88 onward
Continue reducing number of rates of custom duty and sales tax.	1987/88 onward
Reduce maximum tariff rate (other than for specified luxury goods) to 100%.	1990/91
Further action to be taken to reduce maximum tariff rate and compress duty schedule. One-fifth of items with rate above 100% were reduced to 75%. Further action needed.	1992/93 onward
Simplify tariff schedule to a 6-digit level of classification and reduce number of different tariff rates to no more than 6.	1991/92
Curtail special concessions and exemptions on custom duties and sales taxes.	1990/91 onward
Import Restrictions	
Eliminate negative and restricted lists for industrial imports, except for items controlled for reasons of religion and public safety and a small number of highly sensitive items.	1986/87 onward. Complete by July 93
Phase out requirement that barter facilities must be fully used before imports under any other financing sources are allowed.	1987/88

(Table 5 Continued)

(Table 5 Continued)

Industrial Export Promotion	
Remove restrictions on all required imports for direct and indirect exporters.	1986/87
Simplify procedures for obtaining duty exemption/drawback and grant autonomy.	1986/87 onward
Provide additional infrastructure for Export Processing Zone.	1986/87 onward
Prepare and implement plan to strengthen provision and guaranteeing of export credit.	1987/88
Extend coverage of back to back letters of credit to all products and all indirect exporters. Eliminate all export subsidies other than on jute in 1989/90 and phase out jute subsidies.	1987/88 Ongoing 1990/91–1992/93
Remove all import restrictions on items required by exporters.	1990/91
Extend bonded warehousing facility to all exports.	1990/91

Source: Rashid (2000).

the incumbent government to facilitate trade liberalization. This, to an extent, highlights that tariff rationalization episodes are often 'political responses' to a socio-economic phenomenon and not a product of growing recognition of the economic virtues of having 'low-tariff' trade regimes.

Second Inference: Collective Action Problem and Trade Policy Evolution

The second inference is indicative that if an incumbent government is not in a state of crisis and consumers who benefit from tariff rationalization suffer from acute collective action problem, then one could expect that tariff rationalization momentum will be slow or non-existent in 'non-crisis time intervals' as long as ISIs have greater strength to mitigate their collective action problem and offer a substantial campaign contribution in comparison to exporters. Thus, to examine this prediction, we evaluate the relative collective action issues faced by each stakeholder—consumers, exporters and ISIs. We also review whether the employed assumption in the model about the preference structure (i.e., consumers and exporters desire low tariff and ISIs desire high tariff) is supported by evidence. Finally, we examine the economic transformation of Bangladesh in the pre- and post-1990 period to help understand *which* group (especially, ISIs, consumers, or exporters) is likely to exert relatively more influence in the political process and *when*.

1. Import Substitution Industries (ISIs)

Bangladesh inherited a trade policy regime that was characterized by the protection of domestic industries that produced import substitute products. This industrial strategy was based on the popular 1960s idea of 'infant-industry' protection

which was thought to be the appropriate path for a primary exporting underdeveloped economy to create employment through industrialization. However, this ISI's strategy produced neither high growth nor did it generate enough employment to absorb the growing labour force that entered the labour market each year. The scenario began to change following trade and exchange rate liberalization and investment deregulation in the early 1990s that provided impetus to export-led growth while moderately lowering protection to local ISIs.

Clearly, though many ISIs had the potential of becoming internationally competitive in the long run, not all ISIs could be justified on the rationale of comparative advantage. Though direct subsidies were seldom available except for the state-owned enterprises, tariffs and import controls became the lifeline for the survival and sustenance of many ISIs in the face of import competition. With the growth of numbers of ISIs in the country, they organized themselves into various chambers of trade and industry, or as industry associations, which served as their platform to protect privileges already given to them and to have a common voice in seeking additional facilities from the government.¹⁰ These chambers and trade bodies also allowed them to mitigate any collective action problem they faced while lobbying for any particular policy package.

2. Consumers

An issue that has been least recognized in Bangladesh is that higher tariff regimes are instruments for silent resource transfer from consumers to producers. This is because, when it comes to the price of products, the interests of producers and consumers diverge. The former would like to obtain the highest price for their products in the marketplace, while the latter group would prefer greater product choice and quality at a lower price. While producers gain profitability via the 'protection tax', consumers end up paying for it resulting in the resource transfer.

In Bangladesh, value of imported goods in FY2013 amounted to \$36.5 billion or 25.6 per cent of GDP. Those imports were subject to an average of 28.9 per cent protective tariffs. These tariffs on imports generate revenue for the national exchequer, but also raise the price of imported products, thus raising the profitability of domestic producers whose products compete with imports. It is not surprising then to see producer groups actively pursuing policy makers to perpetuate and even enhance the level of protection. That is where the catch lies.

Table 6 shows that there are four broad categories of imported products (basic raw materials (BRM), intermediate goods (INT), capital goods (CAG) and machineries, and final consumer goods (FCG)) of which the first three are imported by manufacturers for usage in the production process. Roughly, 80 per cent of our imports fall in this group, and, surprisingly, the proportion has not varied much over the years. Lower tariffs on these products reduce costs of production. Producers have lobbied hard to get tariffs on inputs lowered, with a good measure of success. As for the imports described as final consumer goods, interests of consumers and producers are in conflict. Tariffs on these imports have been rising, to the benefit of producers, at the expense of consumers.

Domestic manufacturing industry is largely concentrated in this product group, with a small but growing intermediate goods sector. Protective tariffs on these

Table 6. Tariff Protection by Import Categories in FY2013

Import Category	Share (%)	Top Tariff Rates (%)	Average Protective Tariff (%)
1. Basic raw materials	16.53	5.0	13.73
2. Intermediate inputs	44.62	12.0	16.21
3. Capital goods/machinery	22.22	3.0	10.48
4. Final consumer goods	16.63	88.0*	51.40
	100.00		Average: 28.9

Source: Authors' estimates based on ASYCUDA data from National Board of Revenue (NBR).

Note: * includes para-tariffs; excludes alcoholic beverages, cigarettes and cars.

products in FY2013 ranged from 56 per cent for ballpoint pens and paper products to 199 per cent for chocolates and biscuits. These numbers only measure nominal protection. Because tariffs on their imported inputs are much lower, effective protection, which reflects profitability by taking into account the spread between input and output tariffs, would be much higher. Thus, to the extent the tariff raises profitability and displaces competing imports, it protects the local producer and results in a transfer from the consumer to producer.

Furthermore, while consumers *as a group* have an incentive to advocate free trade, each *individual* consumer has no incentive because his benefit is not large compared to the cost and time required to advocate free trade (Krugman & Obstfeld, 2010). In Bangladesh, collective action issues among consumers are likely to be even more acute since there is no instrumental platform for consumers which can bridge the wedge between the existing set of policies and their preferences.¹¹ In fact, between 1971 and 2008, there was no effective institutional arrangement that protected the rights of consumers. It is only in 2009 that the Government of Bangladesh enacted the Consumer Rights Protection Act, 2009,¹² which aimed to ensure consumer protection by realizing consumer's right to quality goods and services at fair prices. However, the overall usefulness of this new law is still questionable and it has no role in shaping the general trade policy of the government in addressing consumer preferences.

On the whole, the second inference we derive from the model makes the assumption that consumers suffer from an acute collective action problem because of their large numbers. Hence, any incumbent government is likely to rationally expect that consumers will fail to commit to their political support function no matter how large they are (in terms of their voting power). Furthermore, the discussed tariff structure in Bangladesh is reflective of the implicit tone of our trade policy, which offers relatively low attention to consumer preferences in comparison to others. As we have pointed out, this is likely to be an outcome of the collective action problem faced by consumers in Bangladesh due to the chronic absence of effective platforms that can advocate consumer concerns (e.g., related to protective tariffs and their price effects) and ineffective institutional arrangements which offer limited protection to consumers in the marketplace.

3. Exporters

Exporters have gained substantial political influence over the past two decades in Bangladesh, as their performance has been impressive in the post-1990 era. In fact it can be observed from Figure 8 that exports as a share of GDP rose from a mere 5–7 per cent in 1991 to 20 per cent by 2011. With rise in the share of exports in the economy, the relative importance of groups who are engaged in ‘exporting’ saw their influence steadily increase in the policy-making domain.

As it is well known, much of the export success rests with the phenomenal growth of the readymade garments (RMG) industry in Bangladesh which exported some \$25 billion in FY2014 (80 per cent of total exports). That makes Bangladesh next only to China as a clothing exporter to the world. Though export concentration in one product (RMG) remains a weakness, the fact that the sub-sector comprises some 5000 factories, and directly employs some 4.5 million workers, it contributes to the making of a political power elite amongst exporters, comprising of ‘woven garments’ and ‘knitwear’ exporters, who are now well organized under the two trade bodies, namely:

- Bangladesh Garments Manufacturer and Exporters Association [BGMEA]¹³
- Bangladesh Knitwear Manufacturers and Exporters Association [BKMEA]¹⁴

As a result, with the relative homogeneity¹⁵ within the export base (which is likely to make policy preference similar) and increased coordination capabilities with the help of important trade bodies, actors within the export sector are likely to face minimum collective action problem while advocating policies or offering political support to an incumbent government.¹⁶

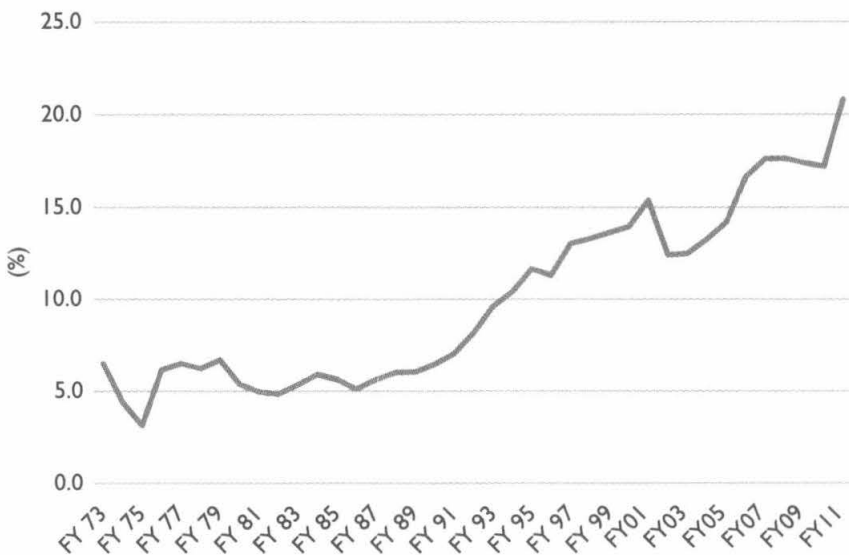


Figure 8. Exports (as % of GDP)

As for trade policy preference, in the case of enterprises operating in the RMG and knitwear industry in Bangladesh, they are allowed special bonded warehouse (SBW) facility for imports of all inputs duty-free plus imports of inputs under back-to-back LC, a facility to pay for imported inputs from export proceeds. However, these schemes which allow duty-free import of inputs are not available as a matter of course to other exporters who must pay duties on imported inputs up front and rely on a dysfunctional duty drawback system that involves transaction costs. Thus, a tariff on imports becomes a tax on exports on two counts: (a) higher cost of imported inputs and (b) higher tariff-induced profitability of ISIs that divert resources away from exports (anti-export bias of tariffs). This highlights the preference of exporters for the low-tariff regime. So, the employed assumption in the model—exporters prefer lower tariff regime—remains valid. More importantly, given their significant stake in the national economy over the last two decades, it is pragmatic to argue that if exporters in fact prefer low-tariff regimes, then their preferences are more likely to matter in the political process in the post-1990 period.

4. Which group mattered and when they mattered?

The second inference notes that as long as consumers suffer from the acute collective action problem—tariff reduction or rationalization momentum will be slow or non-existent in ‘non-crisis time intervals’ as long as ISIs have equal or more campaign contribution capacity than exporters. In observing whether tariff rationalization episodes fit well with the predicted outcome of the employed model, we need to consider one specific issue:

5. To identify non-crisis time intervals when ‘ISIs’ appear to be relatively more influential than ‘exporters’ or ‘consumers’.

We can get plausible answers to the questions raised above by looking at tariff trends during one long non-crisis time interval.

First, in the pre-1990 period, ISIs formed an instrumental backbone of the overall private sector, especially during the 1980s when a small growing manufacturing body started emerging. This is reflected in the growing capacity of the manufacturing sector to absorb a greater share of total employment between 1981 and 1991 (Table 7). The structural change in the Bangladeshi economy between 1970 and 1990 also meant that ISIs were likely to be of considerable political importance given they formed the core private sector base of the formal sector. Table 7 also shows that exports only started to dominate the economic scene of Bangladesh in the post-1991 period. From this, we can cautiously argue that in non-crisis time intervals in the pre-1990 period, ISI preferences—*higher tariff rates and increased protections through quantitative restrictions*—are likely to merit policy consideration due to their dominant role in the economy.¹⁷ Additionally, as the evidence at hand suggests, this is in fact the case that one can see from Table 4 and Figure 7. To be precise, while Figure 8 does not provide the average tariff rates in the pre-1990 period, it is observed in various studies that average tariff rates in the 1980s were more than 125 per cent (Ahmed & Sattar, 2004). In fact, trade-related conditionalities in the industrial structural

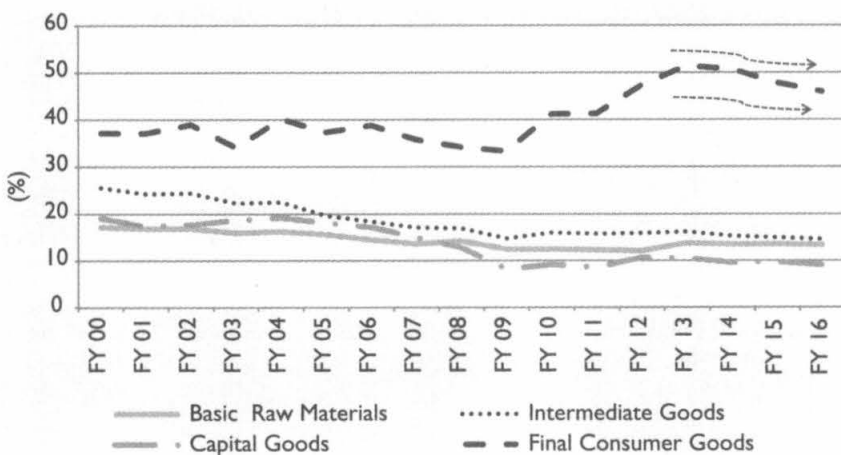
Table 7. The Structure of Bangladesh Manufacturing Sector during FY75 and FY2010

	FY81	FY91	FY2001	FY2010
Size				
Total (per cent of GDP)	11.2	12.9	15.6	17.9
Growth rate (% annual average over the decade ending)				
Total	1.3	5.0	6.9	5.7
Large and medium scale	1.5	4.9	7.0	5.5
Small scale	1.0	5.1	5.8	6.6
Employment				
Share of total employment	8.7	10.1	9.9	11.8
Exports				
Per cent of GDP	4.1	6.8	10.6	17.4
RMG (% of total exports)	0.1	38.9	56.1	77.3

Source: Policy Research Institute Data Base.

adjustment credit in 1986 (ISAC-I) reflects that the donors wanted the tariff to be no more than 125 per cent, which implicitly suggests that tariff structure entertained even higher thresholds. Likewise, Table 4 is also indicative that the number of items in the control lists (an important indicator of trade protection mindset) in fact increased between 1987 and 1989, which correlates well with preference of ISIs during a non-crisis time interval.

Second, a cursory examination of the trends in nominal protection rates of import categories during FY00–2010 (Figure 9)—BRM, CAP, INT and FCG—reveals

**Figure 9.** Average Tariff on Import Categories

Source: Policy Research Institute Data Base.

that the average Net Protection Rate for input categories has been declining much more rapidly than that of final consumer goods whose average nominal protection rate (NPR) remained practically flat if not rising—significantly in the recent past. While the revenue authority sought higher revenue, there were pressures from domestic producers of consumer goods (ISIs) seeking higher effective protection to hold on to the higher rates on FCG while lowering rates on imported inputs used in the production process. Average tariff trends shown in Table 1, Figure 7 and Figure 9 indicate they succeeded. The net outcome of this process is higher effective protection (higher profitability) to domestic producers over time. Consumers, who were at the receiving end of higher tariff-induced prices, bore the costs of higher protection as they were not organized to press for lower tariffs, hence lower prices. Likewise, though exporters also preferred lower tariffs, the revealed tariff trends show that exporter groups lost out to ISIs in keeping average tariffs low, though they were partly compensated by the lowering of input tariffs overall.

As a final point, it is worthwhile to note that we have so far only provided descriptive evidence which offers some *prima facie* evidence in support of the key second inference which pointed out that during non-crisis time intervals, tariff rationalization episodes are unlikely to occur if ISIs have more political clout in comparison to exporters and consumers. This, intuitively, means that policy preferences of ISIs are likely to find political support when they play a dominant role in the economy. At this point, however, we need to assert that we make no causal claim about this noted relationship. The nature of the study and scarcity of relevant data concerning the power structure of the relevant groups of the model limits our capacity to undertake a rigorous causal analysis. Nonetheless, what we do instead is to show that the discussed descriptive evidence from tariff trends in Bangladesh is not in contradiction with the key inferences of the model. This, of course, provides motivation for a greater in depth scrutiny (in future) of the underlying political economy interplay that shapes *when* and *why* tariff rationalization occurs.

Concluding Remarks and Caveats

It is often stated that determinants of trade policy are deep down political (Rodrik, 1995). In this context, this article develops a simple political economy model that evaluates the policy strategies for imposing tariffs (as a core element of trade policy) that are available to an incumbent government. More precisely, the model allows us to make two essential inferences concerning trade policy evolution. First, the model proposes that if the government is in a 'state of crisis', then irrespective of the relative political strength of each group and the collective action problem they face, the government is going to lower tariff to receive donor support. Hence, tariff rationalization is more likely to occur during (or immediately follow) 'crisis time intervals' so that incumbent governments can avail

conditionality donor support. Second, the model proposes that if the government is 'not in a state of crisis' and consumers who benefit from tariff rationalization suffer from the acutest form of collective action problem, then one can expect that tariff rationalization momentum will be slow or non-existent in 'non-crisis time intervals' as long as ISIs have equal or more campaign contribution capacity and collective action strength than exporters.

In addition, the descriptive analysis from Bangladesh provides considerable *prima facie* evidence in support of these basic inferences. In other words, tariff rationalization episodes in Bangladesh have mostly followed or occurred during a state of crisis, but have waned in non-crisis times. This evolution fits well with the insights from the first inference. Additionally, tariff rates on consumer goods for domestic sales are found to remain high during non-crisis time intervals when ISIs played a dominant role in Bangladeshi national economy. This offers sufficient encouragement for viewing tariff rationalization episodes as an outcome of the relative bargaining strength of the key actors in the economy. Now, while it is important to acknowledge that we derive no causal claim from the overall analysis, it can be cautiously suggested that this approach in evaluating tariff rationalization episodes might open new avenues that are more contextually rich in explaining trade policy regimes that are witnessed in developing countries.

This overall analysis also highlights one important issue that merits more in depth research. That is, while tariff rationalization episodes that were witnessed in Bangladesh in the post-1990 period are often described as the outcome of growing recognition of the virtues of trade liberalization within the policy sphere (Ahmed, Mahajan & Mahmud, 2008), the present study is indicative that they are more likely to be a product of political response to the state of balance of payment, growth and political crisis that Bangladesh experienced in 1990–91. This, in essence, means that the effective political commitment towards trade liberalization might still be absent in Bangladesh, and whatever changes we witness in tariff structure, during non-crisis time intervals, are likely to be the outcome of pressure from various interest groups—the core underlying theme of this article.

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Notes

1. Some have, however, expressed their reservation for such prescriptions. For more discussion, see Chang (2002).
2. Nonetheless, the model employed in this article is very simple and it introduces policy-climate-related factors in shaping optimal strategies of incumbent policy-makers. It also discusses the collective action issues faced by each actor in the model to understand how their 'influence' is hindered or facilitated by their respective collective action strength. In this context, the approach is different than Grossman and Helpman (1994), which assumes all interest groups are able to mitigate free rider

- problem within the group dynamics and such issues do not shape the equilibrium strategies.
3. A more condensed discussion of the literature on the political economy of protection is provided in Hillman (1989).
 4. This means if the good is provided to one member of the group, then no other member can be excluded from the benefits of the good. For more details, please review Oliver (1993).
 5. While this proposition is sometimes challenged in the literature on collective action, some empirical examinations have shown that larger groups do in fact produce lower amount of collective action good than medium- or small-sized groups (Agrawal and Goyal, 2001; Gautam, 2002).
 6. For this inference to hold, $\max(\beta) < 1$.
 7. This is very evident if we see Table 5 that summarizes the key components of the structural adjustment programs that substantially facilitated tariff rationalization.
 8. We did not evaluate trends in external debt as Bangladesh never faced any noticeable difficulties in managing its debt.
 9. In fact, the number of items in the control list at the HS 4-digit level reduced sharply between FY1991 and FY1994 (see Table 4).
 10. For example, Federation of Bangladesh Chambers of Commerce and Industries (FBCCI), Metropolitan Chamber of Commerce and Industries (MCCI) and Bangladesh Chamber of Industries (BCI).
 11. The only notable organization that existed between the mentioned time intervals is Consumers Association of Bangladesh (CAB), which is a non-govt. non-political and non-profit voluntary organization that was founded in February, 1978. However, the effectiveness of this body is often questioned as it has failed to advocate the preferences of the consumers (Eusuf, 2006).
 12. For more detailed discussion on the law, please visit <http://www.consumersinternational.org/our-work/consumer-protection-and-law/key-projects/bangladesh-project> Or see, CI (2010)
 13. For more information on BGMEA, please see <http://bgmea.com.bd/>
 14. For more information on BKMEA, please see <http://www.bkmea.com/>
 15. This is because the RMG and knitwear groups are the pivotal players in the entire export sector.
 16. In the 9th National parliament, more than 20 parliamentarians are directly involved with readymade garments or knitwear industry. This to some degree reflects their penetration in the political landscape. For more information, please see: Member Directory, Ninth Parliament of Bangladesh, June 2009.
 17. This dominant role is likely to be associated with a greater capacity to offer campaign contribution.

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