Fiscal Developments in 2014-2015

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Fiscal Developments in 2014-2015: Budget Priorities and Fiscal Spaces for Vision 2020 Targets

Biplob Kumar Nandi[1]
Al Mamun[2]

A. Overview and Summary: National Budget FY15, last budget under Sixth Five Year Plan, was on the whole a bold budget. Like previous budgets, this budget can be considered as an ambitious in nature but achievable, particularly with regard to macroeconomic objectives like real GPD growth and on the spending side. In this current fiscal year, Bangladesh Bureau of Statistics (BBS) has estimated to 6.23 percent of real GDP growth against budget target at 7.3 percent. Although political environment remained stable in the first half of FY15, rebound in imports demands, significant positive growth in remittance, real GDP growth has estimated lower due to slow down in private investments and sluggish export performance. Moreover, Bangladesh government has achieved a little success to increase in public investment, especially in the area of infrastructure, but which is still not substantial to achieve budget growth target. In budget 2015 Bangladesh government targeted to enhance public investments from additional domestic revenues that require tax collections to go up substantially. Public revenue mobilization target in the budget FY15, while higher than last year, was quite feasible in view of Bangladesh's low tax effort. But, it may not be possible to achieve revenue target, while it has been expected 100 - 150 billions NBR revenue shortfall in this current fiscal year. Main sources of NBR revenue shortfall may attribute from domestic VAT, supplementary domestic and income taxes due to slow down in domestic economic activities resulting from political turmoil during last quarter of FY15.On the expenditure side, the development budget, while large in relation to the past, is still low in relation to the development needs of the country. The weak implementation argument, while valid, is not insurmountable with right policies. There is, however, a question about the size of the current spending. There is a benign condition that the projected subsidy spending may actually be lower in FY15 because oil price in international

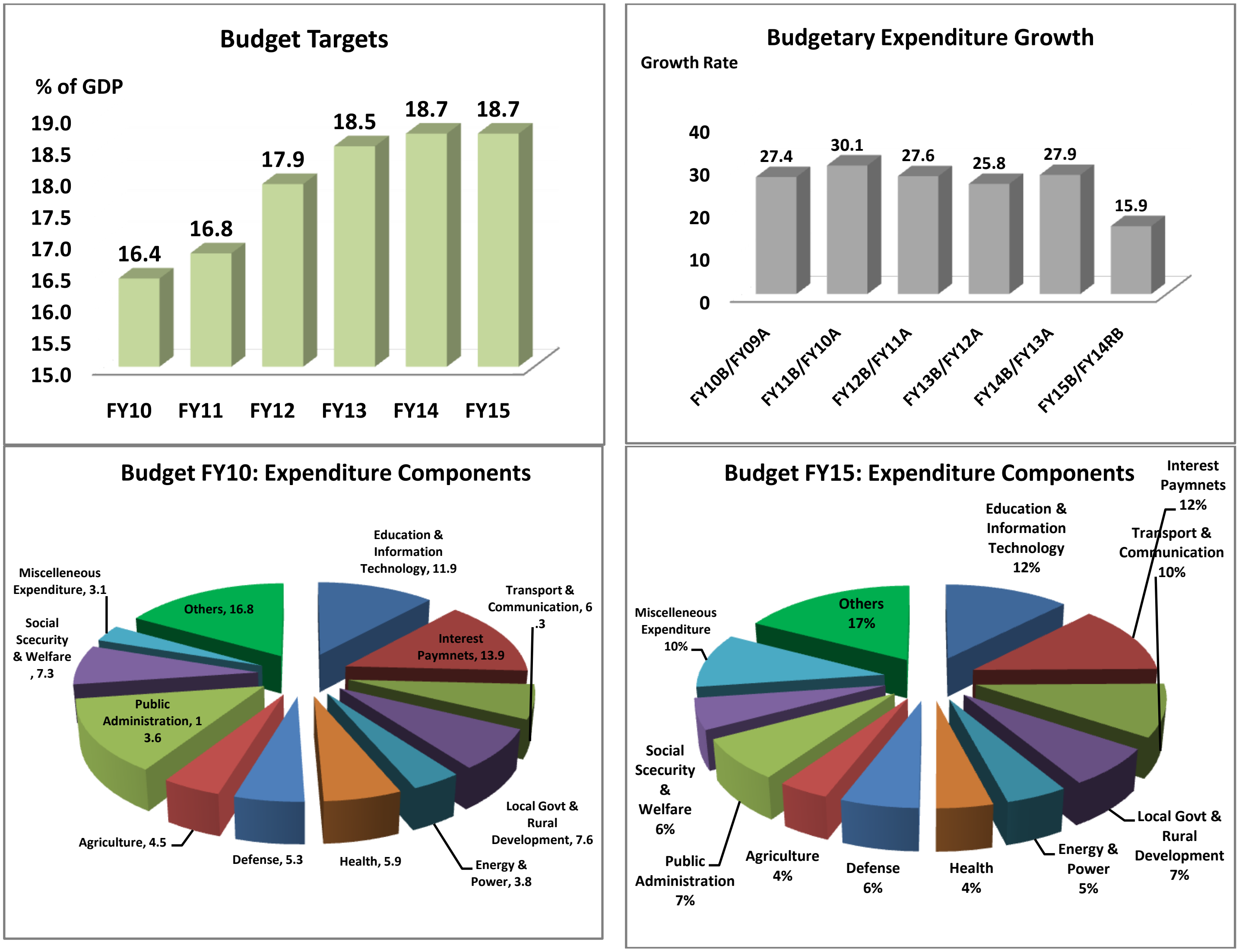
[1] Senior Lecturer, Dept of Economics, East West University
[2] Senior Research Associate (Research Department), Emerging Credit Rating Ltd.

market is in declining trend as well as lower level of world inflation. The pressure from growing subsidies could also release which will remain stable overall budget deficit. On the financing side the main question is whether the government is able to mobilize the projected optimistic increase in foreign financing. If this is not realized, as is likely, this will challenge the consistency of monetary and fiscal policy targets. In case of source of deficit financing, Bangladesh government is still on the right way to limit borrowing from banking system, to increase external financing through FDI and loans. Thus, underlying current fiscal deficit, the ability to keep monetary expansion within prudent limits to prevent inflation and contain favorable overall balance of payments surplus may reduce substantial macroeconomic policy challenge in FY15.

B. Budget Size and How the Resources Allocated:

Although there has been a lot of discussion on the "so called large size of budget," it may not consider the increased allocation as particularly large in view of a number of considerations. If anyone compares FY15 budget with FY14 and other recent budget, it is observable that at 18.2 percent of GDP it was almost same as FY14 budget and a little bit higher than other recent budgets. Thus, with the increased size of the economy and growth demand of the citizens for broad range of public services such modest increases still remain unavoidable.

Bangladesh: Budget Size, Allocations and Budgetary Growth, FY10 and FY15



Source: Budget Documents, Ministry of Finance Bangladesh

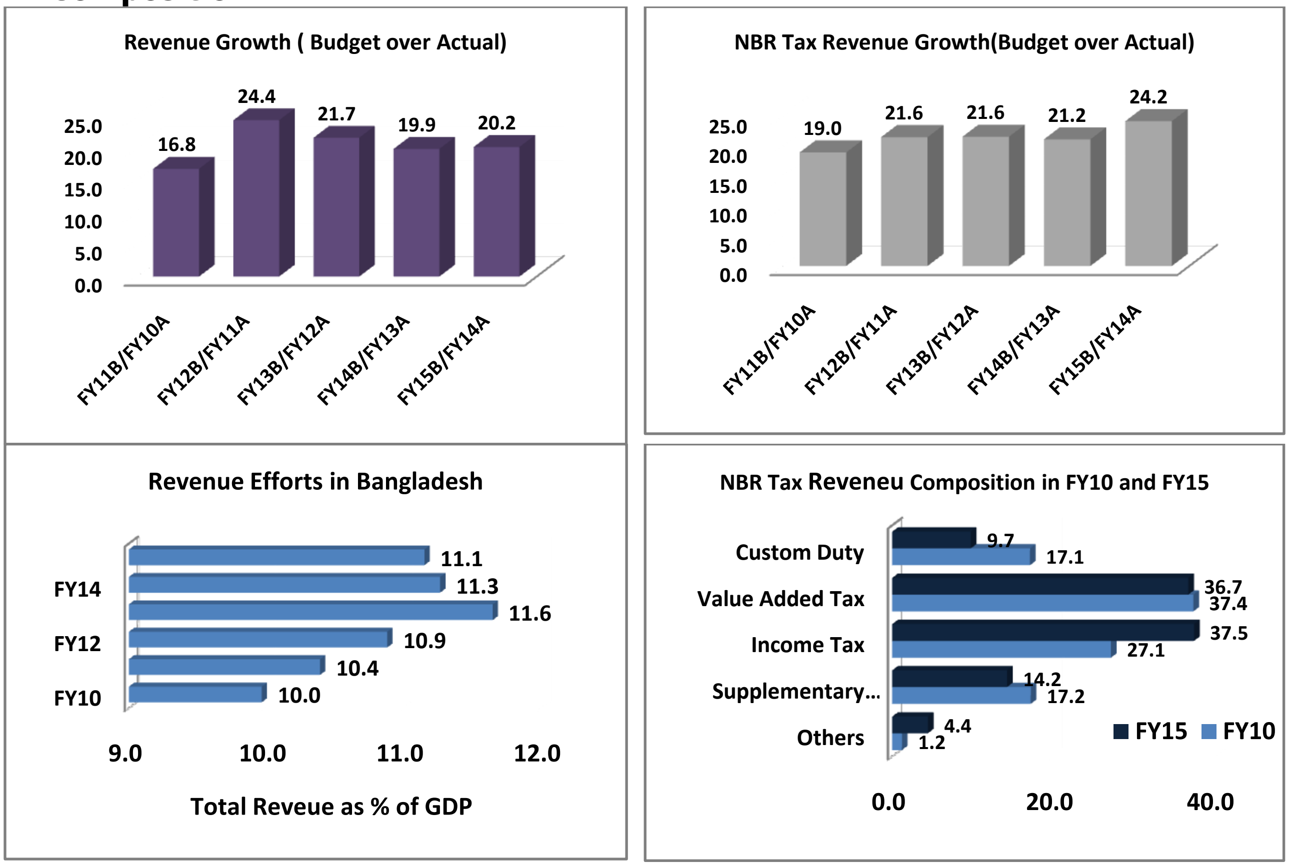
In terms of the increase in government spending relative to the actual expenditure or the revised budgetary expenditure of the previous years we in fact observe a major deceleration in expenditure growth compared with the expenditure growth observed in the preceding years. As a matter of fact, expenditure growth in FY15 is 15.9 % over the revised FY14 budgetary spending, which is the lowest increase recorded in any year of the Awami League government. In terms of overall resource allocation over the years we do not observe major shifts, although allocations for transport and energy/power have increased in line with government priorities for infrastructure and allocations for education, health and social safety net programs have decreased in relative terms. It is also interesting to observe that despite reservations expressed by many quarters, total interest payments as a share of total spending has declined in recent years but at 12 % of total spending in FY15 is very close to spending on education and information technology.

A matter of concern is the very rapid increase in miscellaneous expenditure, the share of which increased by more than three folds to 10 % of total spending. Such a large increase in the unidentified miscellaneous category to almost 10% of the budget is a matter of concern pointing to lesser transparency and potential weakening of expenditure control. In recent years the allocations for key social sector programs witnessed a secular decline in relation to GDP and the total budget. This decline had to stop compared with FY14 budget. We are pleased to observe that FY15 budget has made a significant move to reverse the secular decline, which is a commendable move. Thus, we hope no cuts will be made in these allocations and efforts will be made to improve allocation and targeting efficiency of these important programs

C. Revenue Mobilization and Targets:

Budget FY15 targets total revenues to fix at 11.1 % of GDP in FY2015 from 11.3 % (Figure 2). This ratio implies that lower revenue efforts remains, no remarkable improvement have been incurred to enhance higher revenue efforts. In FY15 budget total revenue has been projected to increase from budget over actual by 20.2 percent, while NBR tax revenue has been projected to increase from actual over budget by 24.2 percent, which was ambitious in line with scarcity of tax automation in income tax and VAT system association with lower tax base in both of income and Value Added Tax. Moreover, 24.2 percent growth in FY15 budget was not prudent because we have no good record to achieve this higher revenue target. Additionally, most of the revenue efforts come from NBR tax revenue performance- especially from domestic VAT tax revenue and Income tax. Thus, without tax automation, no increase in tax coverage, and without implementing fully new VAT Law 2013, it seems to be dark to achieve budget target. On the other hand, transition of tax structure underlying with economic growth may play a vital role to establish equitable and efficient tax system of an economy. If we compare NBR tax revenue compositions in FY10 with FY15, the, we observe that share of Value added tax remain stagnant - proportion of VAT import decreases over years, but proportion of VAT domestic increases relatively at lower pace implying higher VAT efforts. Conversely, we observe positive development in case of income tax share trend, which registers higher proportional increase during last five budgets, while declining trend reflected in case of custom duty and supplementary duties because of reforms in tax laws and more involving in international trade which force to keep lower import duties over year of every budget.

Figure -2: Revenue Growth Budget over Actual, Revenue Efforts and Composition

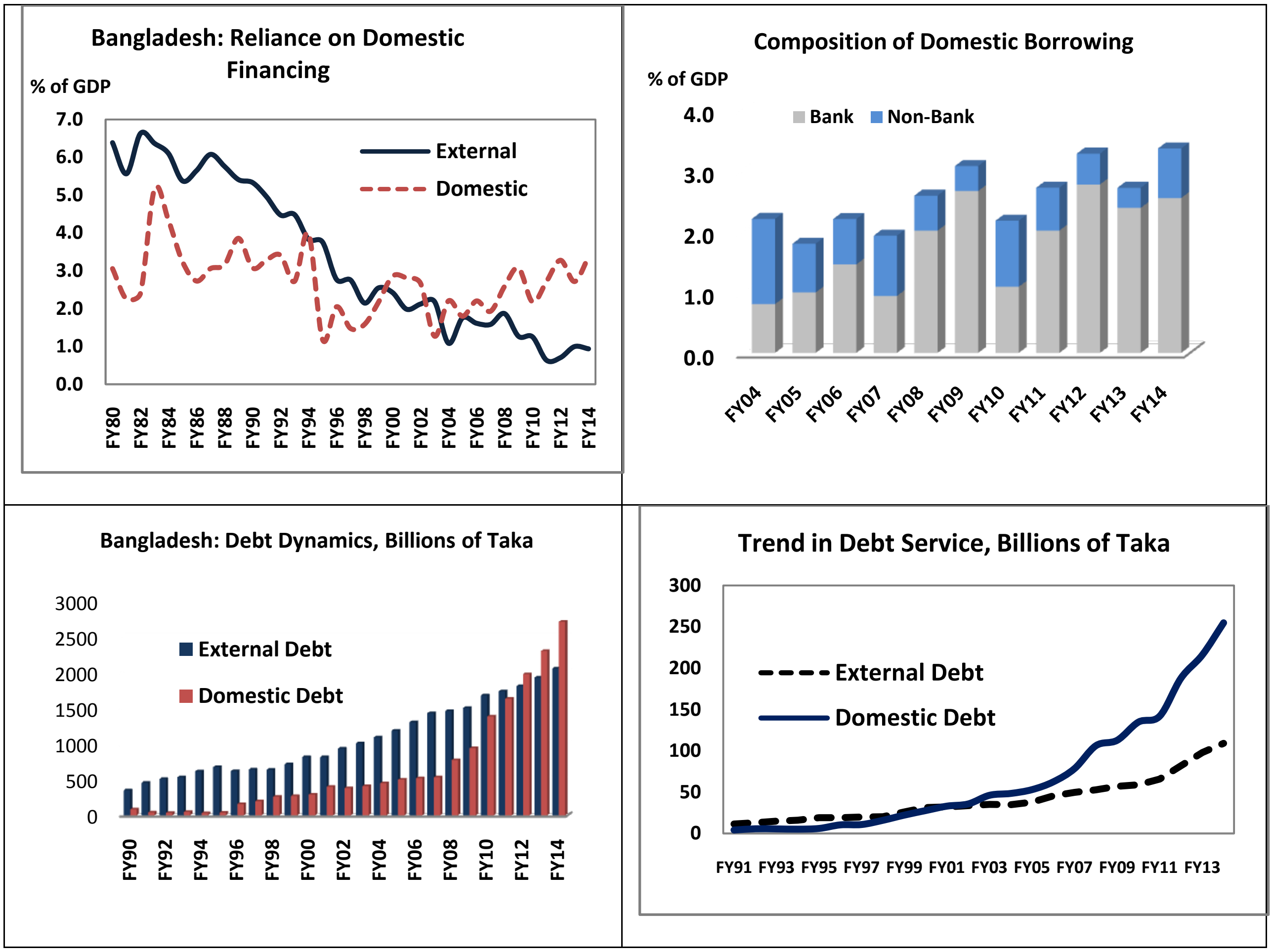


Source: Ministry of Finance, Bangladesh

D. Sources of Financing, Deficit and Debt Target:

Government's fiscal deficit level of 5 percent of GDP in the context of more than 6 percent real GDP growth is appropriate and should not give rise to any debt sustainability issue. However, emerging pattern in the composition of financing with much greater reliance on high cost domestic financing and relatively short maturity structure and associated very high degree of rollover is a matter that should get more attention in the financing strategy of the government. Moreover, heavy reliance on National Savings Certificates (NSD) and short-term treasury bills give birth to huge amount of debt service payments while larger proportion of debt services come from domestic debt, indeed amount of domestic debt stock remain still low compared with external debt stock. This huge cost from domestic debt financing should give way to long-term treasury bills and bonds, infrastructure bonds, etc, with proper secondary market and a well-developed yield curve (which does not exist today in Bangladesh). Thus, government would need to diversify its sources of financing with proper mix of domestic and external financing, and on both fronts indentify market based additional sources of financing.

Figure 3: Dependence on Domestic Financing and Entails High Rollover Risks



Source: Ministry of Finance, Bangladesh

The widening trend between external and domestic financing since FY06 is a matter of concern. From figure-3, it is explicit that domestic debt stock exceeds external debt after FY11, implying heavy reliance on domestic borrowing from high cost sources – NSD, short-term T-Bills and Bonds, etc, becomes stronger year over year. Moreover, it proves a bad indication of domestic debt management because domestic debt service is almost double with almost same level of both domestic and external debt stocks in terms of taka. If no attention is given to higher utilization of external concessional aid in pipeline and new commitments, debt servicing would become increasingly costly for the budget, limiting government's scope for discretionary spending. At the same time access to both domestic and external debt would need to be significantly broadened. On the domestic front traditional reliance on non bank borrowing through National

Saving Directorate (NSD) and short-term T-bills should be supplemented with long-term T-bills and bonds (10-30 year T-bills and bonds). On the external financing front, greater and regular access to international capital market through issuance of long-term bonds will be important.

E. Budget FY15: Where We Stand?

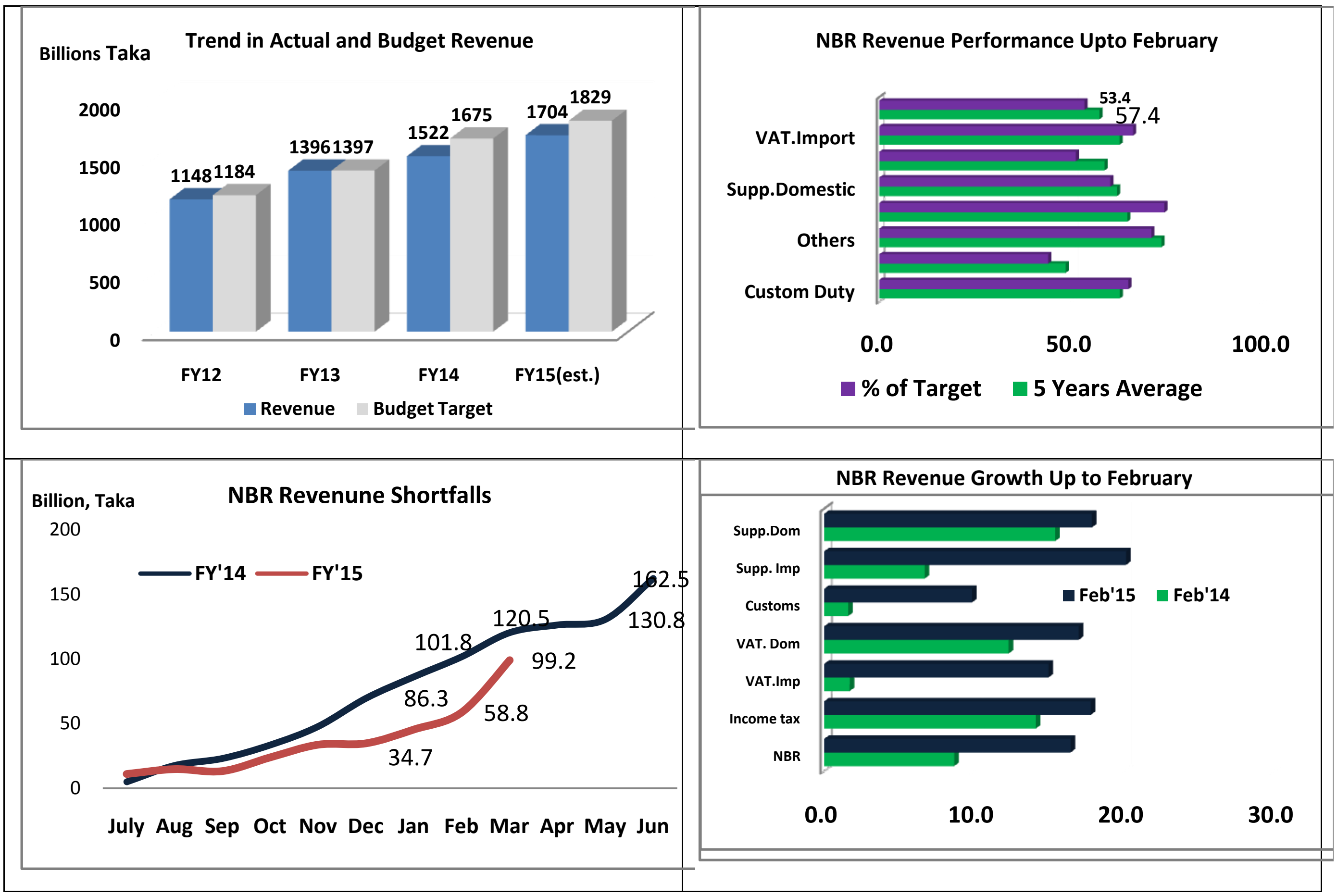
Despite higher budget allocation in infrastructure development expenditure, huge expected NBR revenue shortfall in ongoing fiscal year and in line with lower expected subsidy costs due to decrease in oil price in international market, fiscal policy stance in FY 10 has not been expansionary at all. Thus, overall fiscal deficit including grant is projected to be 4.1 percent of GDP, despite original budget targets of 5 percent of GDP. Actual fiscal deficits expect to be lower because of failure to implement ADP allocation fully. Moreover, sluggish NBR revenue performance in both domestic and import –based taxes and budgetary savings from the terms-of-trade gains due to downward trend in oil price squeezed at a larger extend to limit fiscal deficits. Before discussing rational upcoming budget association with announced government new fiscal stances, we should scrutinize budget performance during first three quarters in current fiscal year in terms of revenue developments, expenditure utilization and government's sources of financing.

Revenue outlook:

Although NBR revenue collections seems to be improving, closer to target, while huge shortfall in previous fiscal year, NBR revenue collections remains sluggish in nature during month of February in FY15. Due to continued sluggish NBR outlook compared with previous year, total revenue collections for this current fiscal year are estimated at Tk. 1704 billion registering 125 billion below the target. Main drivers of this shortfall of total revenue is NBR tax revenue collections up to February, which is less buoyant despite lower base and growing import demands. During first eight month of FY15 NBR revenue collection scores 99.2 billion taka below budget target (See Figure -3), which is lower compared to same period of FY14. Thus, NBR revenue collections have been estimated in ending of current fiscal year to closer amount of 120 to 150 billion taka.

NBR revenue collection has been estimated relatively lower in current fiscal year because NBR tax revenue efforts record remarkably adverse due to slow down in domestic economic activities, persistent political turmoil at the beginning of third quarter of FY15. During the first eight months, growth in NBR revenue (16.4%) was much higher in FY15 while FY14 total NBR as well as all of the components recorded significantly slower growth compared to that in the last FY14. Based on the 5-year collection pattern, actual revenue through February was 4.0 % below 57.4 % target required to achieve the budget target. If we observe NBR performance in various components, then major sources of NBR revenue shortfalls come from domestic-based revenue- especially from domestic VAT and income tax, while reverse trend observes in case of import-based tax collection, indicating higher growth earned in custom duties and VAT import duties.

Figure 4: Fiscal and Budget Implementation, 2014-15, Up to March

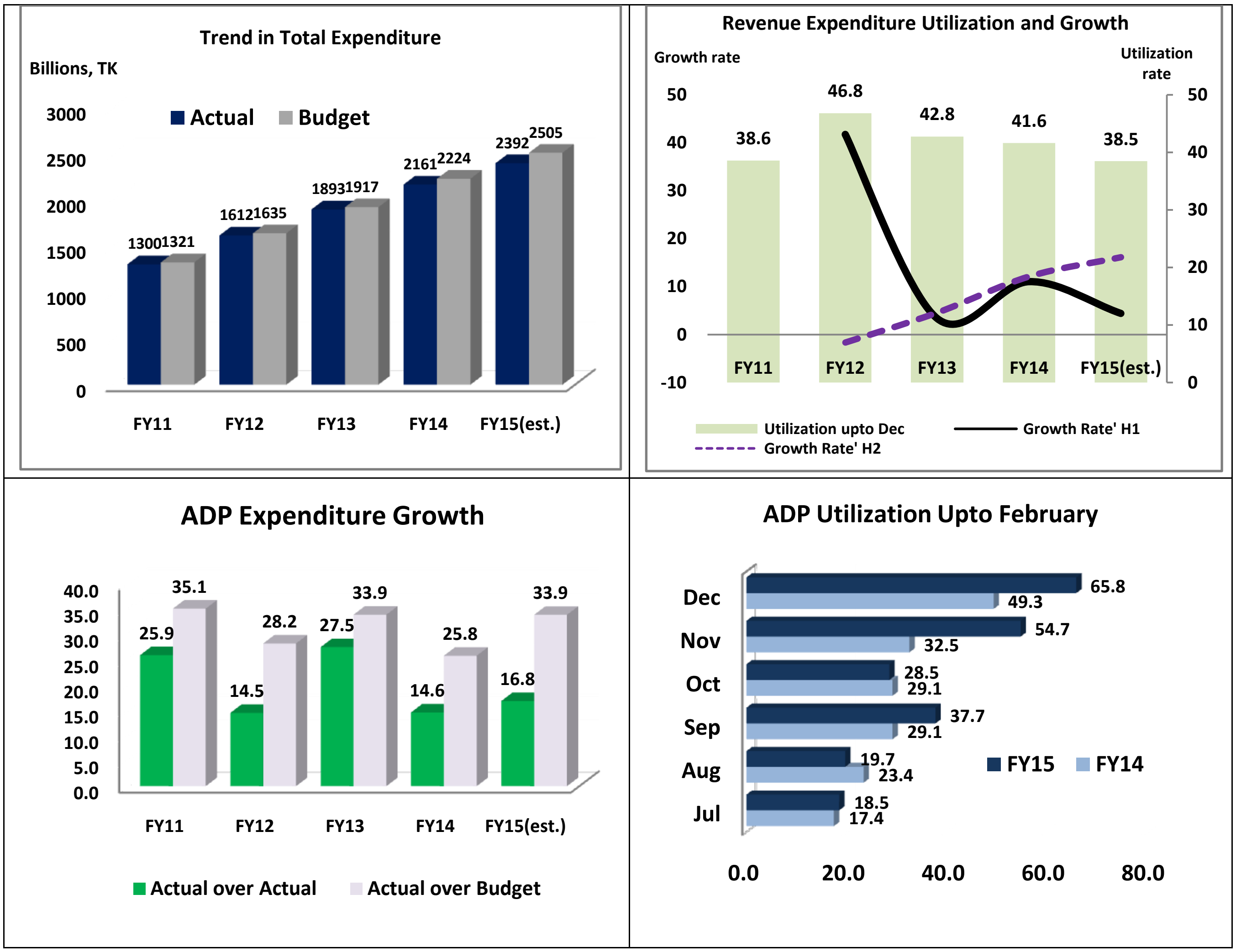


Source: National Board of Revenue, Bangladesh

Expenditure Outlook:

Beginning of budget FY15, total expenditure allocations was 2505 billion of taka, which registered 15.9 percent, increase actual over budget. Historically, actual expenditure fell short against targets due to huge expenditure savings from ADP allocations, implying lack of implementation capacities in lying with institutional weakness and scarcity of funding in mega projects. Moreover, recent declining trend in oil price in international market may reduce huge subsidy pressure from energy sectors. Thus, current expenditure may be fall short against budget target. Government has revised ADP target, which was 100 billion down than budget target due to political unrests hampering various projects implementation on time.

Figure 4: Expenditure Outlook and Utilization for July-December, FY15



Source: Ministry of Finance, Bangladesh

Revenue expenditure utilization rate always achieve budget target, which is closer to full utilization of target, but sometimes it may vary due to up and swing in subsidy allocations, highly correlated with oil price fluctuations in international market. This year government may gain benefits from money savings accrued to subsidy allocation in budget due to lower oil price**.** If we observe first half growth of revenue expenditure, then its trend sharply declines from same period of previous year, also lower utilization rate compared with same period as previous year, this lower growth explains government subsidies declines in energy sectors (Figure -4).

On the development expenditure front, it is clear that size of actual ADP expenditure will be lower in current fiscal year. Moreover, there is no success story that over actual ADP expenditure growth exceeds previous year Actual over budget allocation (Figure- 4). In the current fiscal year, ADP utilization rate, which registers to 49.3 percent, remains still lower till July -December compared with same period of FY14. Thus, greater expenditure savings from energy subsidies and revised lower ADP size may limit overall fiscal deficits in end of FY15.

F. Deficit Financing and its composition:

Historically, Bangladesh government managed well fiscal vulnerability to keep lower level of fiscal deficit. But, if we observe the composition of fiscal deficit financing, it looks inefficiency in domestic debt management policy, and, thus we have to pay more money as debt services in every fiscal year, especially growth pattern of domestic debt service is stronger than external debt services, given almost same level of domestic debt stock as well as external debt. This may be an alarming situation in future, which gives birth to rollover risks to pay debt. In current fiscal year, Bangladesh government manages well to limit domestic borrowing- bank borrowing keeps low level at the end of first half of FY15, while government are able to improve inefficiencies to implement external financed projects, this helps to open up new door for external market loans and grants. Thus, net external financing flows increase more during first half of FY2015 compared with same period of FY14, which may reduces loan requirement from bank and non-bank sources at the end of FY15.

G. Budget Priorities, Challenges and Fiscal Spaces for Vision 2020:

Against the overall assessment made above, and considering upcoming expected huge fiscal expansion- New Pay Scale, Mega Infrastructure Projects, etc, what should be budget priorities in upcoming 2015-16 budget to align with Seventh Five Year Plan's target real GDP growth and investment acceleration, is a remarkable concern before formulating new budget FY16. In this section, we want to highlight key risks and challenges to provide more revenue expenditures in lying with upward size ADP expenditure subject to relatively minimum fiscal deficit.

Firstly, if government implements new pay scales, it requires allocating more 180 to 200 billion as revenue expenditure, which increases revenue expenditure to GDP by an amount of 1.8 to 2 percentage of revenue expenditure to GDP in FY16. Moreover, ADP demand grows every budget, if we assume that government increase ADP allocation by maintaining 15-20 percent actual over budget growth, which is previous three years average, then, government should allocate handsomely large money in ADP allocation. This is very crucial to enhance public investment to foster investment to GDP ratio to 32 percent in last year of Seventh Five year Plan. Thus, it may increase fiscal deficit to GDP, which may reach exceeding 5 percent of GDP.

Secondly, more than 5 percent deficit to GDP align with 7 to 8 percent growth, may quite sensible if government improve deficit financing, which is to reduce lower dependency from short term T- bills and bonds, NSD, and to increase more commitments for external financing because our interest payments in domestic debt instruments grow an alarming rate which may hinder growth path in future, crowds out more private investments.

Thirdly, there are a lot of examples in world economy that higher revenue expenditure creates more inflation. This may be natural due to higher demand for goods and services, price speculation for business men and traders for new pay scales. Thus, higher inflation in domestic economy causes to currency devaluation, and finally, government would have to bear extra payments for external debt servicing.

Finally, it may not be rational, oil price remain declining trend for upcoming years. When oil price starts to follow increasing trend government will have to provide more energy subsidy to control energy price, while government has taken initiatives to scale up energy prices.

Underlying this reality, what should be nation's priorities for Budget FY16? – Some important expectations are noted below:

- The emphasis on transport, power, and making serviced lands available to potential investors (domestic and foreign) is appropriate. However, these large infrastructure projects need to be translated into real action on the ground through speedy implementation. Past experience with regard to implementation of major transport and power projects have been fraught with cost overruns, long delays, and quality control issues. Most of these projects mentioned in the budget have been under consideration for a long time. This time, if we really want to see a real change in private sector investment sentiment, these large projects must get off the ground and their actual implementation be started in FY16.

- Budget implementation should be done in such a manner those guards against potential revenue shortfall. This would essentially imply prioritization of projects and programs with a view to setting aside projects which may be considered non-priority or controversial. In particular, Ruppur Atomic Power Plant and Rampal coal based Power Plant near Sunderbans may easily be postponed while awaiting comprehensive appraisals and environmental and social impacts assessment of these projects and after completion of open public debate on the appraisal and environmental reports.

- On the financing of FY16 deficit, government should not be more ambitious before ensuring commitments of new financing, if shortfalls on external financing front will occur, creates huge pressure on domestic financing. Already, reliance on domestic debt grows faster rate, push tremendous domestic debt service pressure, may intensify more domestic debt burden if government takes fiscal expansion in FY16 budget. Thus, to reduce pressure on domestic debt, government has to find a better way to utilize more foreign aid disbursement. Greater access to program financing in support of major structural reforms(e.g., in the financial sector, civil service reform, in the operations of the Railways, RMG sector relocation to new RMG Villages or Parks) may help faster disbursement of funds and improve policy environment.

- Moreover, a medium and long –term financing strategy should be developed by the Ministry of Finance to broaden the sources of both domestic and external financing taking into account the maturity or rollover risk and diversification of sources of financing. Government should emphasis to long-term bonds, improvement in domestic bond market including secondary bond markets.

- Government should focus more to allocate higher in case of health, education and technological sector to enhance productivity of factors of production. But, it is still surprising that allocation in both education and health sector were lower compared to previous budget in terms GDP ratios in last two budgets. So, government should be more concern about to ensure higher allocation in both education and health sector in budget FY16.

- Trend in higher allocation for social sectors in previous budget are welcome, but this shift has to be sustained over the medium term. At the same time quality of spending on education and health and better targeting of resources for social protection need to be improved. The commitment to adopt a new National Social Security (NSS) program should start for speedy implementation of the strategy along the lines already approved by secretary's Committee.

- Government should address monetary policy in align to expansionary fiscal policy stances by government in upcoming budget to control inflation, interest rate and exchange rate. A firmer approach to bring down inflation to the average level of Bangladesh's trading partners would certainly help reduce the tension. That would also help bring down the whole interest rate structure including lower lending rates.