Fiscal Management and Revenue Mobilization

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Prepared as a Background paper for the Seventh Five Year Plan

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Fiscal Management and Revenue Mobilization

I. Background and Introduction

Bangladesh despite being a least developed economy has had a relatively strong track record of prudent fiscal management and has made some progress in revenue mobilization efforts in the last decade. Good fiscal management in terms of keeping the fiscal deficit and public debt at sustainable levels, despite limited public sector resource mobilization, has served as the anchor to Bangladesh's continued macroeconomic stability. The good fiscal management notwithstanding, public sector service delivery in terms of coverage and quality were seriously constrained by the limited success in resource mobilization.

This paper presents a general overview of Bangladesh's fiscal structure in terms of the size of the government; performance in terms of revenue mobilization; expenditure patterns in terms of allocation and recent shifts, if any; role of fiscal policy over the Plan period and beyond and challenges on the revenue and expenditure sides; and policy and administrative reforms which would be needed to realize the medium- and long-term fiscal objectives. As we are passing through the final year of the Sixth Five Year Plan (SFYP) period, the discussions will be cast against the objectives/targets established under the SFYP.

Against the backdrop of reviewing the past fiscal performance, especially the performance under the SFYP period, the paper will try to set the fiscal objectives and goals of the Seventh Five Year Plan. In this context, it will assess the revenue performance in recent years, highlight the shortcomings and achievements, and set the achievable and yet manageably challenging targets for the upcoming five years. On the expenditure side, the focus will be on ways of achieving efficiency in government spending, the required restructuring is sectoral spending patterns or resource allocation in line with the socio-political needs of the population and overall improved management of budgetary structure.

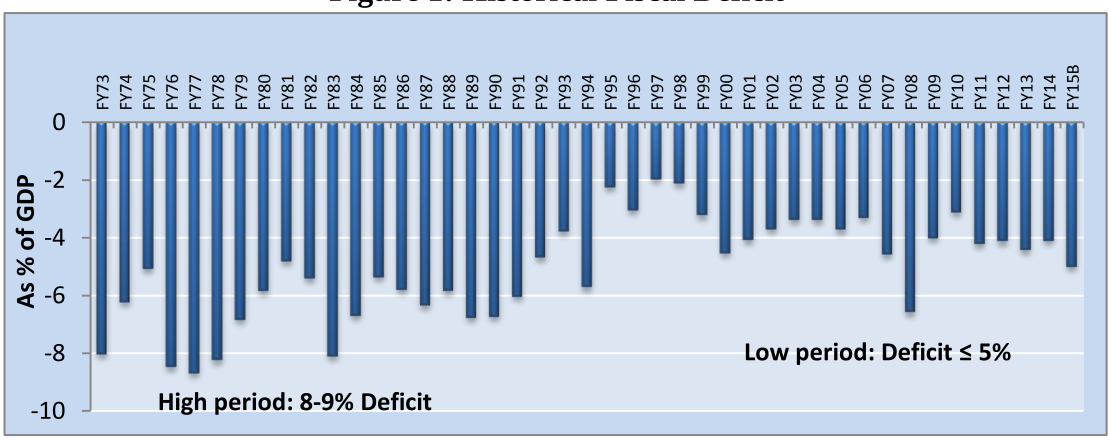
II. Bangladesh's Fiscal Structure and Fiscal Management

Bangladesh has faced several challenges over the years in coping with pressures for government expenditure management which has at times been limited by the revenue generating capacity of the NBR, while keeping in mind the developmental needs of the population and the country. While the first two decades of the country's fiscal history has been marked by several shocks as well as trial and error in fiscal management strategies, the 1990s and 2000s has been relatively structured and comparatively stable. There have been several important changes in the fiscal deficit and financing, particularly improvements in deficit management and financing strategies. The expenditure structure has evolved steadily in line with the changing priorities of the government keeping in mind the development goals and needs of the population. Revenue generation has improved significantly and there has been a marked shift in composition of the revenue basket as well with the focus shifting more towards direct taxes on the domestic front from import-based sources. A detailed discussion on developments in each of the fiscal components- **Fiscal Deficit and Financing, Government Expenditure, Revenue**-and their management along with their historical contexts follows.

A) Fiscal Deficit and Financing:

Until mid-1990s the overall fiscal deficit was on the high side ranging 8%-12% of GDP in most years. During those initial years Bangladesh was receiving much higher external financing in the form of loans and grants, allowing the government to maintain higher level of deficit (excluding foreign grants) without any significant reliance on domestic borrowing and particularly from the domestic banking system. A look at the historical trend shows that the deficit was more than 5% of GDP almost consistently during FY73-FY94 and the deficit levels also went up to 9% of GDP on several occasions. However, since then the government has managed to contain the overall deficit at levels below 5% of GDP, except for one or two outlier years due to special circumstances, which is a great achievement for a developing country like Bangladesh which has been faced with political instability.

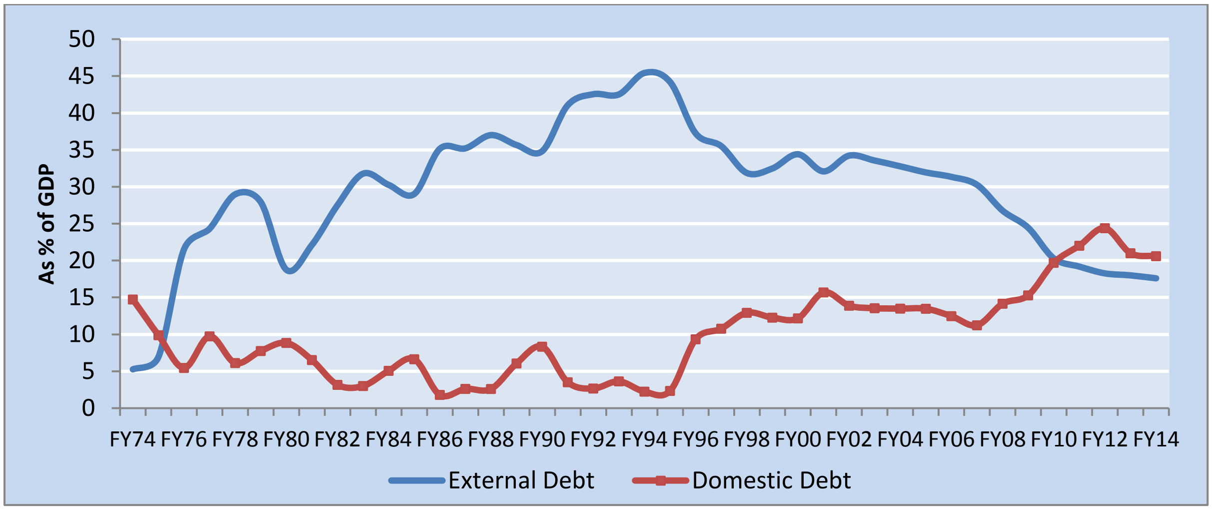
Figure 1: Historical Fiscal Deficit



Source: Ministry of Finance.

The financing strategy adopted by the government entailed use of highly concessional external financing from official multilateral (like the World Bank and ADB) and bilateral official sources for the purpose of budget and balance of payments (BOP) financing. During the first two decades of Bangladesh, the export base was very narrow and dominated by primary agricultural products (like Jute and tea) and inflow of workers' remittances was also limited. In those early and economically difficult years, the government needed higher levels of external financial support to pay for the imports necessary for maintaining food security and for running the economy. A large part of the support coming from the development partners were provided to the government which enabled it to continue with large fiscal deficits without creating macroeconomic instability. At its peak, Bangladesh's reliance on external financing was more than 10% of GDP.

Figure 2: External and Domestic Public Debt

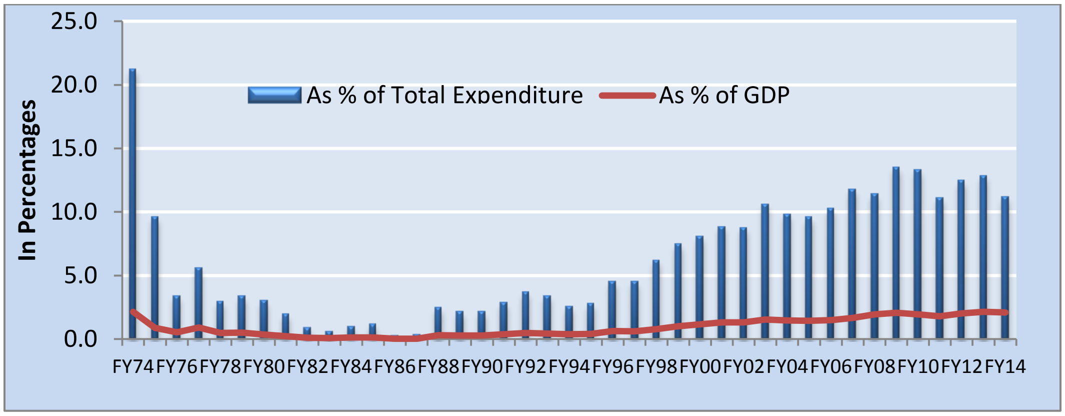


Source: Ministry of Finance, Bangladesh Bank

As a result of the reliance on external financing, during the first two decades, the fiscal deficit financing mix was heavily tilted towards external borrowing and recourse to domestic borrowing was very limited. The result was a rapid buildup of external debt while domestic debt burden was extremely low (Figure 2). Since the external debt was incurred on extremely concessional terms and with long amortization periods, although external debt/GDP ratio exceeded 45% of GDP by mid-1990s, it did not create any balance of payments difficulties.

The strategy however shifted since mid-1990s, as the availability of external financing became more difficult with growing demand for donor support from the Eastern Europe (after the collapse of the former Soviet Union) and African countries. Bangladesh economy also gained strength in the mean time in terms of expansion of RMG-based manufacturing exports and growing inflows of remittances from Bangladeshi workers abroad. As a result, the economy was in a position to reduce its dependence on external official financing and withstand the domestic demand pressure arising from higher domestic borrowing by using domestically generated foreign exchange receipts. This shift in financing, led to the steady buildup of domestic debt since mid-1990s and the consequent rapid increase in interest payments on domestic debt (Figure 3).

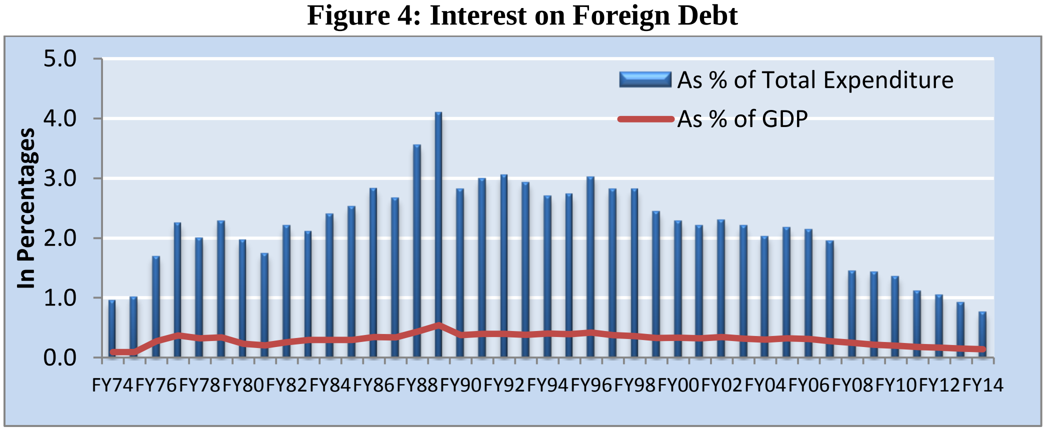
Figure 3: Interest on Domestic Debt



Source: Bangladesh Bank

While the increased reliance on domestic financing was needed from that time, it might have been overdone and led to diminishing use of foreign resources. Increasingly government machineries have become more interested in using domestic budgetary resources and avoid use of concessional foreign financing due to higher quality of scrutiny for use of such funding. The high cost domestic financing has over the years led to a rapid buildup of domestic interest payments while foreign interest payments are declining rapidly in relation to GDP or export proceeds (Figure 4). Although both domestic and foreign debts are broadly of similar size (about 20% of GDP) in 2011, interest payments on domestic debt is more than 10 times higher than the interest payments on foreign debt. From debt sustainability point of view there is no immediate concern, but a yellow light is blinking because of the rapid growth in interest payments on domestic debt and the government must watch out and make course correction before the light becomes red.

Figure 4: Interest on Foreign Debt



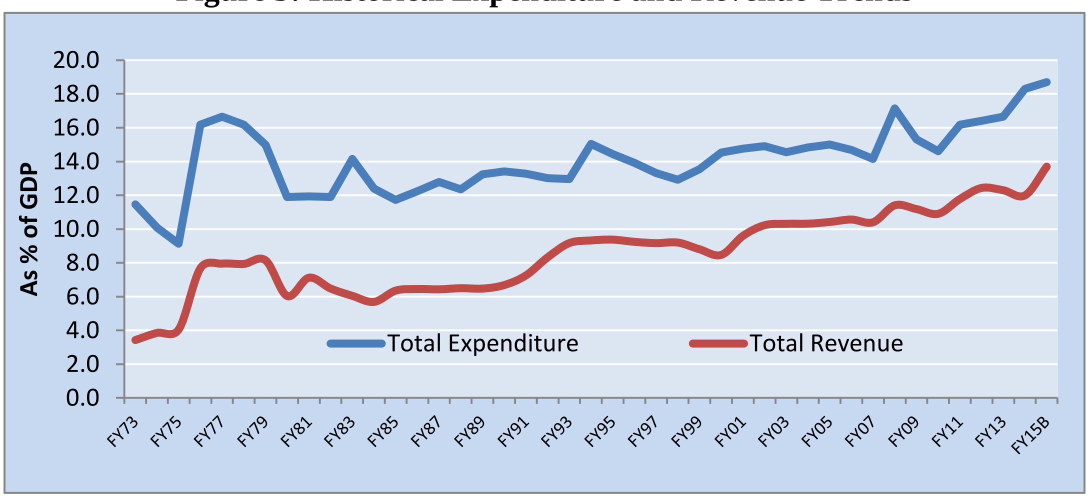
Source: Bangladesh Bank

Additionally, there is a growing need for restructuring the sources of domestic financing. Primarily, the brunt of the finance is derived from the bank borrowing rather than from national saving instruments. In the last two fiscal years, the demand for government savings instruments has been low which forced the government to resort to borrowing from the banking sector. In the last fiscal year, the low demand was acerbated by the political mayhem in the country which led to low confidence in the government and hence government issued saving instruments. There is also a need for greater variety and increase in duration of the saving instruments, so as to attract more investors. At present the maximum duration of savings instruments is 5 years, which is very low in comparison to other countries where the duration goes up to 20-30 years. This move could also lead to better management of interest rate payments and reduce the risk of duration mismatch which is prevailing at present.

B) Government Expenditure Scenario:

Despite being one of the least developed economies, Bangladesh's fiscal management has generally been very prudent. Expenditure has always been limited at around 15% of GDP for about 4 decades, although pressures for higher spending were always there. In the last decade or so, Bangladesh has broken out of the 15% limit with the government expenditure reaching more than 18% in FY15 Budget. The main reason behind this recent expansion of the government size is primarily due to increased revenue collection (primarily from NBR sources) as is evident from the chart below (Figure 5). Every time the revenue collection dipped there was a resultant decline in expenditure as well, in order to maintain the deficit at a sustainable level.

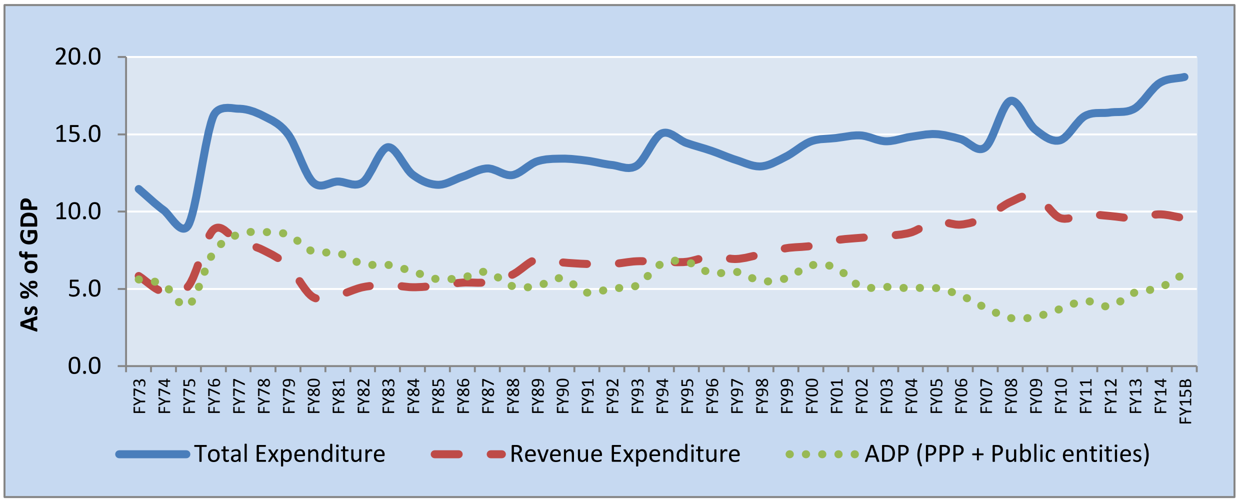
Figure 5: Historical Expenditure and Revenue Trends



Source: Ministry of Finance

While revenue expenditure has remained mostly stable and grown gradually, development expenditure in the earlier decades was erratic. Moreover, in comparison to the first three decades, the overall development expenditure to GDP declined in the 2000s. The amounts have increased substantially in nominal terms but remained stable in terms of GDP. A closer look at the expenditure pattern shows that bulk of the increase in expenditure was from increases in revenue expenditure which has increased almost steadily from 5% of GDP in the earlier decades to 10% of GDP in the last 10 years or so. This is an expected rise since the size of the government has increased over the years, along with substantial increases in the pay scale of government employees and a burgeoning pension bill. Government spending on various social programs also increased. Additionally, rise in government borrowing over the years has added to the interest and debt servicing payments, which has also added to the expenditure growth. In comparison, while the Annual Development Plan (ADP) expenditure has seen increases in nominal terms, it has declined from above 8% of GDP in the late 1970s to about 5%-6% of GDP in the later decades and currently (Figure 6).

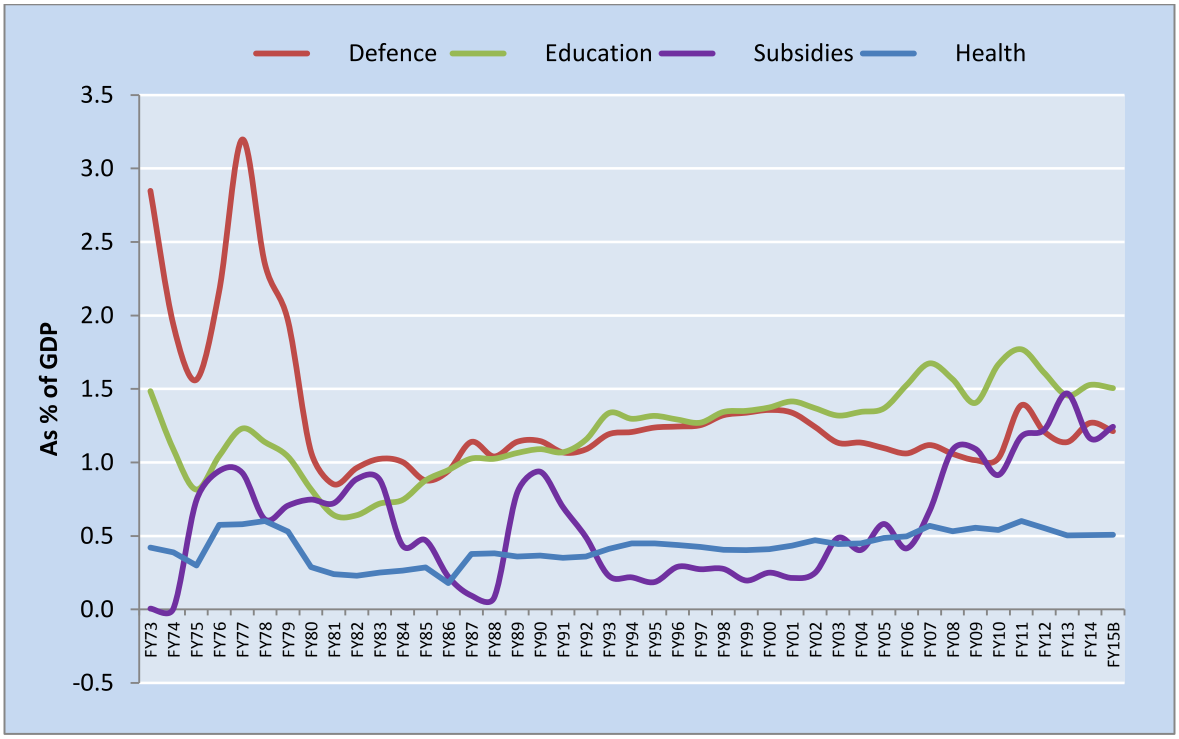
Figure 6: Historical Expenditure and Broad Categories of Expenditure



Source: Ministry of Finance.

B) (i) Revenue Expenditure- A breakdown of the revenue expenditure into major components clearly shows the shifts in government priorities over time (Figure 7). In the decade following the independence of the country, the dominant expenditure was in the defense sector which peaked 1977 amounting to 3.2% of GDP which was partly because of the military regime that was in power at that time. Since then however, the trend has been on the decline. The focus has over time shifted to social sector expenditure, with the main focus being on the education sector. Education sector expenditure has increased slowly from below 1% of GDP in the late 1970s to above or at 1.5% of GDP in the last decade. While this is progress, it is not a substantial increase but quality of expenditure has improved as is evident from the education sector indicators shown Table 2. While the government has been successful in increasing net enrollment at the primary education level to 97.3% till 2013, the 80.5% cohort reaching grade 5 in the same year shows that about 16.8% of the students are dropping out of school. Health expenditure has been mostly steady around 0.5% of GDP which is not a good sign since improvement in healthcare services has been a crying need of the population over the decades and there is a long way to go. Health indicators (Table 1) under the MDG goals show that solid progress has been made in reducing infant and under age-5 mortality, which has been commended by international agencies since neighbors India has been unable to achieve it yet. However, maternal health indicators show there is still a long way to go in order to achieve the MDG targets. Finally, subsidy expenditure has been weighing heavily on the budget over the years and has reached historical highs in recent years. While the rate was constantly below 1% of GDP over the years, since 2007 onwards the rate has jumped to above 1% level reaching a high of 1.5% of GDP in 2013.

Figure 7: Major Components of Revenue Expenditure



Source: Ministry of Finance

Table 1: Health Indicators in MDG Goals

MDG Goals and Indicators	2005	2011	2013	Target 2015
Goal 4: Reduce child mortality				
Target 5: Reduce by two thirds by 2015 the under 5 mortality rate				
Indicators:				
Under 5 Mortality Rate (per 1000)	68	53	41	50
Infant Mortality Rate (per 1000 live births)	-	43	33	31
Goal 5: Improve Maternal Health				
Target 6: Reduce by three quarters, by 2015, the maternal mortality ratio				
Indicators:				
Maternal Mortality Ratio (per 100,000 live births)	348	194	-	143
Births attended by skilled health staff (percent total)	16	32	-	50

Source: Health Bulletin 2013, MOHFW, WHO

Table 2: Education Indicators in MDG Goals

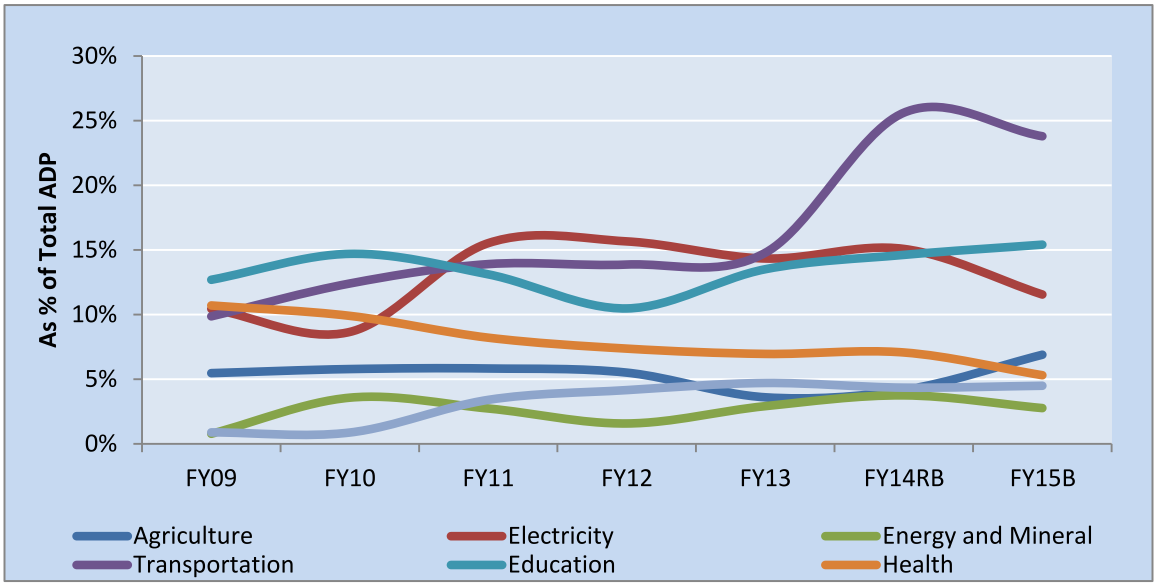
MDG Goals and Indicators	2005	2010	2011	2012	2013	Target 2015
Goal 2: Achieve Universal Primary Education						
Target 3: Ensure that all boys and girls complete a full course of primary schooling						
Indicators:						
Net enrollment ratio in primary education	87.2	94.8	94.9	96.7	97.3	100
Percentage of cohort reaching grade 5	52.9	67.2	79.5	75.3	80.5	100

Source: Bangladesh Primary Education, Annual Sector Performance Report – 2014, DPE

B) (ii) Annual Development Program: The annual development program (ADP) has played a key role in the development of Bangladesh since its inception. In recent decades however, the ADP has declined in terms of GDP in comparison to the 1970s and 1980s. This is a cause of concern since Bangladesh has many pressing development needs that must be addressed if the country is to achieve its goal of establishing itself in the Middle-Income Country rank. The pattern of ADP sectoral allocation over the years clearly shows the changing priorities and needs of the country at various periods.

In recent years the major focus has been on six sectors- Agriculture, Electricity, Energy and Minerals, Education, Health and Transportation. Figure 8 below shows that during FY09-FY11, the education sector was given priority over all the other sectors, which was followed by transportation. While this was a healthy indication of the social development goals of the presiding government, it shifted focus away from the equally important power sector. Lack of sufficient power has been a major problem for the manufacturing industry of the country and therefore a reduction in development funds directed to the sector did not bode well for the economic health of the country. The pleas of the business community suffering due to inadequate power supply was heard by the government and they responded by providing the power sector with the highest allocation of ADP in FY12 and FY13. However, this trend was discontinued in light of the controversial Padma Bridge project gaining primary focus of the government. Since the government decided to build the bridge using its own funds, its allocation to the Transportation sector (which includes the Bridges Division) increased at a historical level. In FY14, the transportation sector accounted for almost one-fourth of the entire ADP allocation, which is the highest allocation for a single sector in Bangladesh’s fiscal history. An increased focus on one sector necessarily means that other sectors will suffer from low allocation of development funds due to the overall budgetary limitations of the government. Almost all of the remaining five sectors saw a decline in allocation, particularly the power and health sector. Padma Bridge would be a major step in infrastructural development by connecting the Northern and Southern parts of the country with proper road linkages, which would greatly aid the development of the northern regions. However, such a major shift in government priorities without taking into account the slowdown in social sector and power sector development raises questions regarding the political motivation behind the project. The Padma bridge is expected to have a great derivative contribution to the economy, but the government must realize this project is not a one-stop answer to the mounting infrastructure needs of the country.

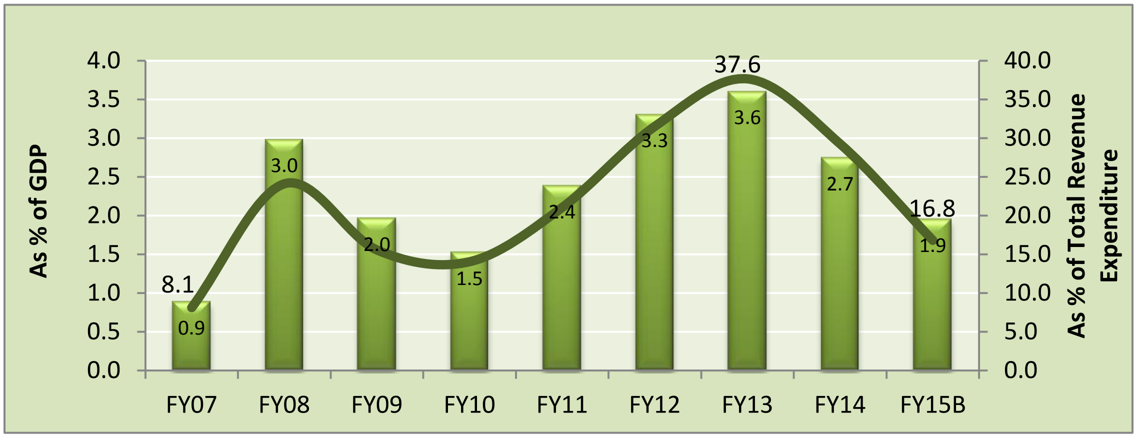
Figure 8: ADP allocation to Major Sectors



Source: IMED, Ministry of Finance

B) (iii) Subsidy: The subsidy bill of the government has been on the rise since FY10 and peaked at FY13 reaching 3.6% of GDP and accounting for 37.6% of the revenue expenditure as shown in Figure 9 below. This is a huge increase in subsidy in the span of six years from 0.9% of GDP and only 8.1% of the total revenue expenditure in FY07. Increase in subsidy is known to cause hindrance in competition and lower efficiency of the recipient sectors. Additionally, when subsidy bills increase to the levels reached in FY13, it takes a huge bite off government funds which could be better utilized elsewhere. While the amount has decreased in FY14 to 2.7% of GDP it still accounted for almost 30% of the revenue expenditure of the country. The government aims to reduce this further in FY15, having set a target of 1.9% of GDP and reducing it by almost half to 16.8% of the total revenue expenditure. With energy prices in the international market declining by almost 25% in 2014 and some basic fertilizer (hydrocarbon based) prices being linked to petroleum and gas prices also on a declining trend all major kinds of subsidies such as electricity, fuel, and fertilizer subsidies should decline markedly in FY15.

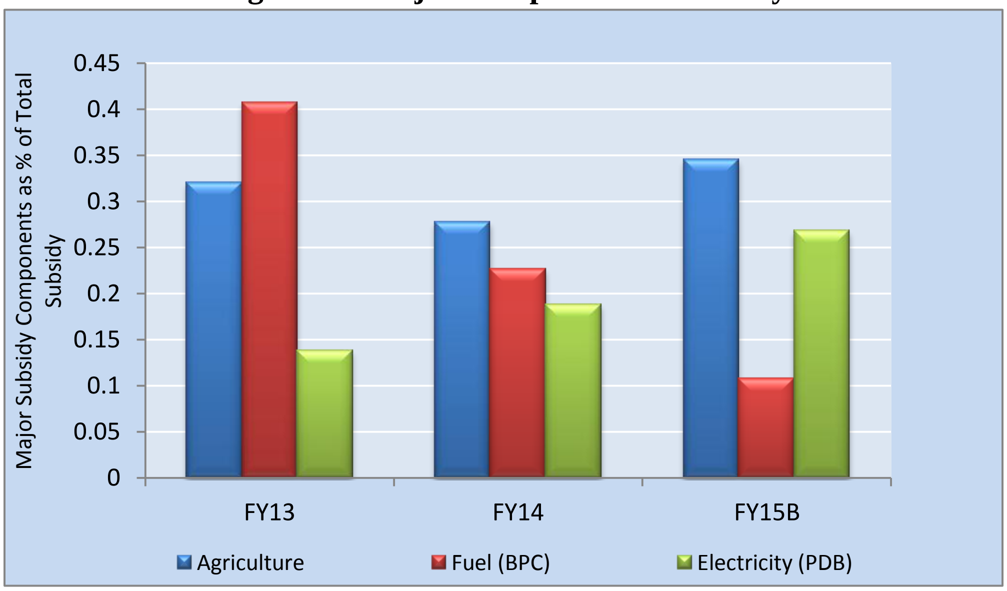
Figure 9: Total Subsidy



Source: Ministry of Finance

The trend of the main subsidy components in Figure 10 simply shows that the government has tried to direct increased assistance each year to the sector which required it. In FY13, rise in fuel prices in the international market was creating upward pressure on domestic fuel prices therefore about 40% of the total subsidy was directed to this sector. While FY14 did not see any massive upheaval in any of the sectors, the subsidy budget for FY15 shows that government plans to direct almost 25% of total subsidy to the electrcity sector. In contrast, the subsidy to the fuel sector in FY15 is expectected to be the lowest since FY13, therefore indicating that the government is expecting a decline in fuel prices in the international market.

Figure 10: Major Components of Subsidy

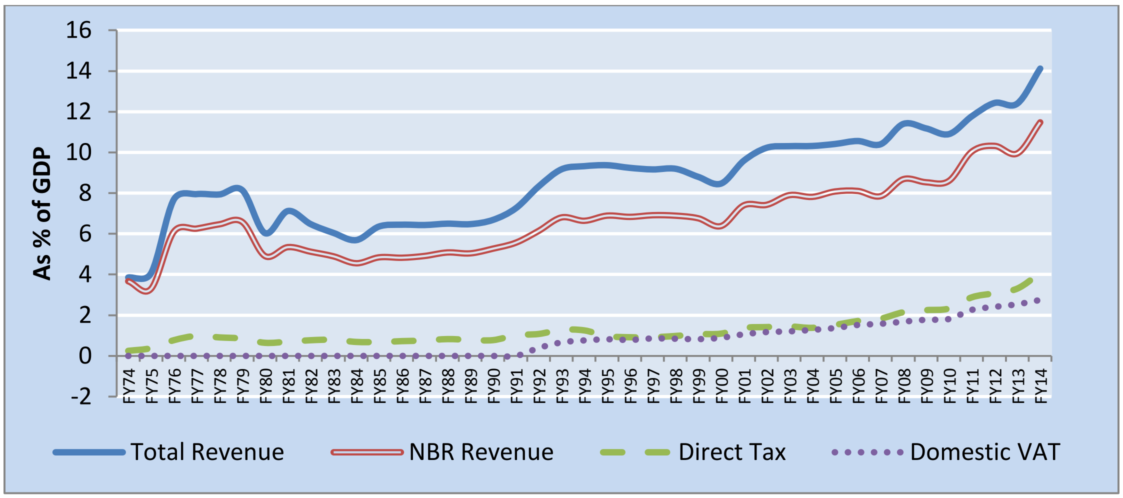


Source: Ministry of Finance

C) Revenue Performance:

Over the last several decades Bangladesh's tax system has undergone some structural transformation. In terms of revenue generation, the performance however has been rather disappointing with the tax/GDP ratio still standing just over 10% mark, one of the lowest in the world. Non-tax revenues at 2% of GDP did not show any sign of improvement over many decades. With the starting of trade reforms and introduction of VAT, dependence on customs duty has declined and the relative importance of domestic based taxes like VAT and direct taxes has increased.

Figure 11: Revenue Components



Source: Ministry of Finance, National Board of Revenue

Historically, tax resource mobilization in Bangladesh has been well below the level of most countries at a similar stage of economic and social development. This below-par resource mobilization impeded economic growth and social development. Until recently, the collection of tax revenue in Bangladesh has been low averaging at about 10.2 percent of GDP until FY14. (Table 3).

Table 3: Tax Effort in South Asian Countries, 2010-2014 (As % of GDP)

Countries	FY11	FY12	FY13	FY14	Average Tax Revenue*	Average Income tax*	Average Value added tax*	Average GDP per Capita US$
Bangladesh	10.1	10.4	11.0	10.5	10.2	3.1	3.7	959.0
India	16.3	16.3	17.2	17.9	16.6	5.6	6.9	1526.5
Nepal	13.0	13.9	15.3	16.3	14.4	3.5	7.5	674.7
Pakistan	9.3	10.2	9.8	14.0	10.6	3.5	3.8	1159.0
Sri Lanka/1	12.9	12.0	11.6	-	12.4	2.5	3.4	2692.9

Source: Ministry of Finance of- Pakistan, Nepal, India. Central Bank of Sri Lanka, NBR Bangladesh, IMF World Economic Outlook

Note: Columns with an asterisk indicates the average ratio during 2010-2014, except for data for Sri Lanka which is the average ratio during 2009-2013, since data for 2014 was unavailable.

Some modest reforms implemented over the FY08-FY12 have yielded some positive results in terms of revenue outcomes. Overall tax revenues now exceeds 10% of GDP (Table 4) and the structure of taxes has improved as reflected in the falling share of trade taxes and an increase in the share of income and consumption (VAT) taxes. Even so, the tax effort falls short of the performance in most South Asian countries.

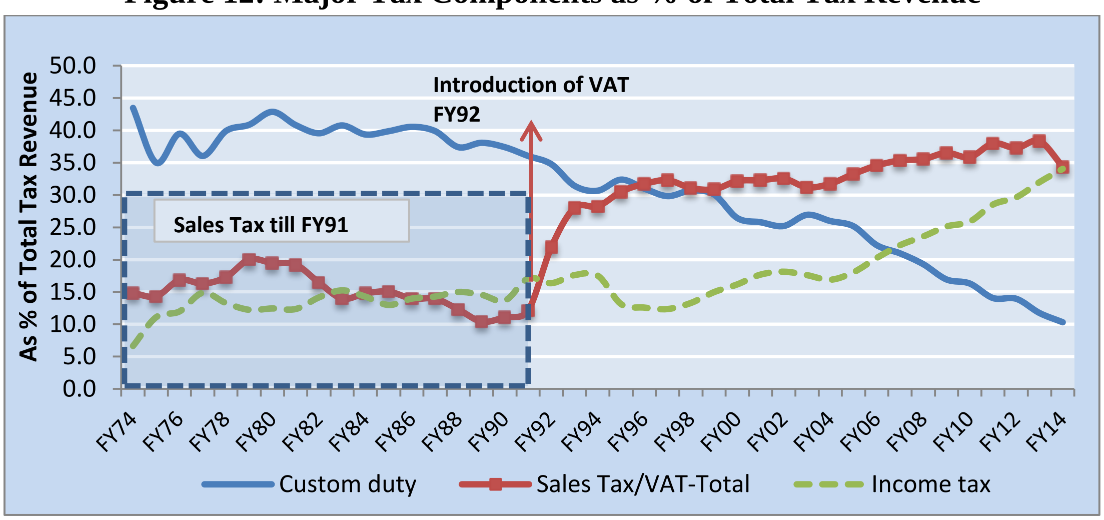
Table 4: Tax Revenue of the Central Government in Bangladesh

In percent of GDP	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Tax Revenue	8.5	8.5	8.2	9.1	9	9.4	10.1	10.4	11.0	10.5
NBR Tax Revenue	8.1	8.1	7.9	8.7	8.5	9	10	10.3	10.5	10.1
Import-based tax	**4.1**	**3.7**	**3.3**	**3.6**	**3.4**	**3.3**	**3.5**	**3.4**	**3.1**	**2.8**
Custom duty	2.1	1.9	1.7	1.8	1.5	1.5	1.4	1.5	1.3	1.2
VAT Import	1.4	1.4	1.3	1.6	1.5	1.4	1.6	1.5	1.4	1.3
Supplementary Duty	0.5	0.4	0.3	0.3	0.4	0.4	0.5	0.5	0.4	0.38
Domestic-based tax	**4**	**4.4**	**4.5**	**5.1**	**5.1**	**5.7**	**6.5**	**6.9**	**7.4**	**7.3**
Income tax	1.5	1.7	1.8	2.2	2.3	2.5	2.9	3.1	3.6	3.6
VAT Domestic	1.4	1.5	1.6	1.7	1.8	2	2.3	2.4	2.5	2.5
Supplementary Duty	1	1.1	1	1.1	1	1.1	1.2	1.3	1.2	1.16
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Non-NBR tax	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4

Source: Ministry of Finance, Bangladesh

Historically, a number of efforts were made to strengthen tax revenue mobilization and improve the tax structure. In 1991 Bangladesh embarked on a major tax reform through the introduction of the VAT system. Simultaneously, significant reduction of import tariffs happened. Prior to these reforms, trade-based taxes dominated the tax structure in Bangladesh with customs duty alone accounting for about a third of tax revenue during the first two decades (Figure 12). Following the introduction of VAT in 1991, the share of VAT revenue increased substantially growing to 29% in the decade of 2004-14, while the share of customs duties declined to 10.8%.

Figure 12: Major Tax Components as % of Total Tax Revenue



Source: National Board of Revenue

Revenue lost from the trade-based taxes was compensated through the expansion of VAT coverage to many services and as well as at the wholesale and retail levels. Though the base of the VAT system has been expanded, due to political expediency, numerous distortions were also introduced over time. Because of these problems, the VAT system underperformed considerably in terms of revenue generation compared with its potential.

It is evident that a narrow tax base, widespread exemptions, and administrative inefficiencies are the main factors behind low tax-to-GDP ratio in Bangladesh compared to the neighboring/comparator countries. This also implies that tax reforms over the last decades could not bring about significant changes in Bangladesh's tax efficiency and productivity.

One redeeming feature is that in terms of buoyancy[1] Bangladesh ranks the highest among the South Asian countries with a tax buoyancy ratio of 1.15 (Table 5). Direct taxes appear to be slightly more buoyant than indirect taxes. Higher buoyancy ratio of direct tax indicates that the growth rate of direct tax was faster than its base and the potential for raising further tax revenue collection from this source still exists. Within the indirect taxes, the estimates of buoyancy ratios reveal the higher potential of domestic VAT for raising tax revenue.

Table 5: Tax Buoyancy[1] among Selected Asian Countries

Countries	**Tax revenue**	**Income tax revenue**	**Indirect tax revenue**
Bangladesh	1.15	1.34	1.28
of Which:			
Domestic VAT			1.54
VAT-import			0.74
Custom Duty			0.81
India	0.76	1.01	0.63
Pakistan	0.89	1.14	0.97
Sri Lanka	0.87	0.84	0.86
Indonesia	0.91	0.82	1.01
Philippines	0.89	1.05	0.88

Source: PRI Staff Estimates

Compared to potential, the tax effort in Bangladesh is still very low (Table 6)[2]. Five Asian countries, viz., Indonesia, Philippines, Singapore, South Korea, and Sri Lanka each have an

[1] Tax revenue buoyancy is defined as the percentage change in tax revenues to percentage change in GDP. In contrast, tax elasticity excludes the impacts of both tax policy (base effect with an unchanged tax administration) as well as tax administration (efficiency in raising additional tax revenue from the same base with an unchanged tax policy).

[2] Tax effort measures the ratio of actual tax collection as a share of GDP to potential tax collection as a share of GDP. The potential collection or taxable capacity is the predicted tax to GDP ratio that can be estimated with a cross country regression, taking into account a country's specific macroeconomic, demographic, and institutional features.

estimated tax effort index above unity implying the full utilization of their revenue potential. Among others, Pakistan, and Thailand have an average index greater than or equal to 0.9. Average tax effort for Bangladesh is 0.657. It may be noted that Bangladesh is ranked the lowest in terms of tax effort among the selected countries. Additionally, the tax effort for VAT is slightly higher than only one other country in the list, and it is higher than only two countries in the list for income tax. The comparator table also indicates that efficiency in collection of VAT is somewhat better than that of income tax. Tax efforts remain higher even among the comparator African countries.

Table 6: Tax Efforts[2] in Selected Countries (for the most recent years)

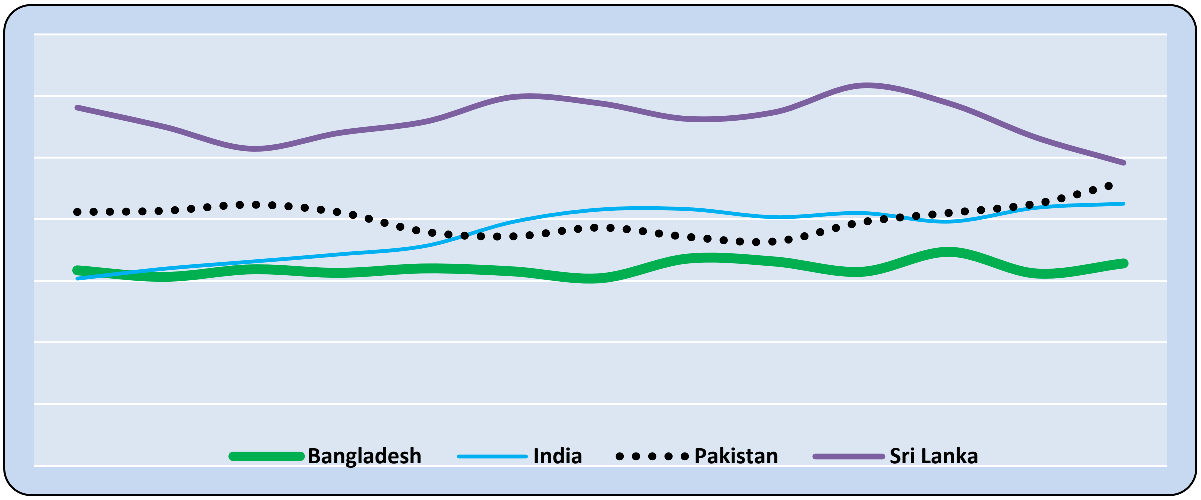
Country	Tax efforts	Income Tax efforts	VAT Efforts
Bangladesh	0.657	0.531	0.567
India	0.850	1.491	0.765
Pakistan	0.920	1.279	1.007
Sri Lanka	0.983	0.640	1.722
Nepal	0.668	0.522	0.729
Korea republic	1.004	2.953	2.953
Philippines	1.040	1.324	0.743
Bhutan	0.690	1.066	0.687
China	1.015	0.923	1.170
Cotd I vore	1.047	0.419	0.557
Ghana	1.613	0.692	1.082
Indonesia	1.247	1.400	1.514
Kenya	1.309	1.886	1.394
Malaysia	0.848	1.104	0.614
Thailand	0.891	0.495	0.992
Vietnam	1.556	1.902	1.080
Uganda	1.029	0.812	1.398

Source: PRI Staff Estimates.

A review of tax efforts among the South Asian countries shows that Sri Lanka ranks the highest and despite some fluctuations it has maintained its strong performance over time (Figure 13). Pakistan started well in second position but over time its tax effort has deteriorated. India started from a lower position but its tax effort gained momentum and is now almost at par with Pakistan. Bangladesh ranks the lowest. Its tax effort did not improve much until very recently.

In order to find the relationship between tax effort and tax share in Bangladesh, the pair wise Pearson correlation coefficients are estimated. The estimated correlation coefficients for total taxes, income taxes and VAT at domestic stages are 0.859, 0.899, 0.836, respectively; all being significant at the 1 percent level. The results suggest a high correlation between tax effort and tax share, implying that tax shares can be used as a proxy to measure tax performance and efficiency in taxation process in the country.

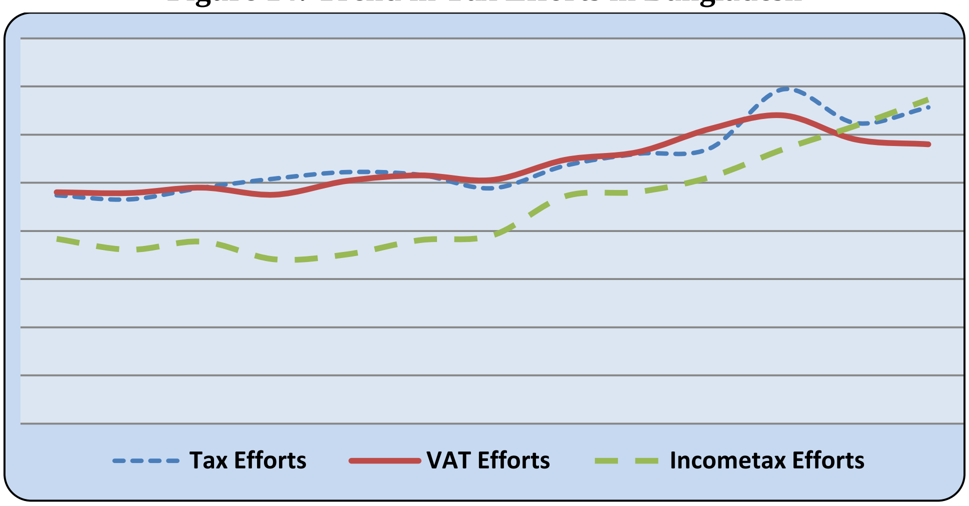
Figure 13: Trend in Tax Efforts in South Asian Countries: FY01-FY13



Source: PRI Staff Estimates

A closer analysis of Bangladesh tax efforts shows that tax efforts for direct taxes has increased over the period while indirect taxes have slowed down (Figure 14). The improvement in direct tax effort has somewhat offset the deterioration of indirect tax effort and therefore, the overall tax effort has increased modestly in Bangladesh over the period.

Figure 14: Trend in Tax Efforts in Bangladesh

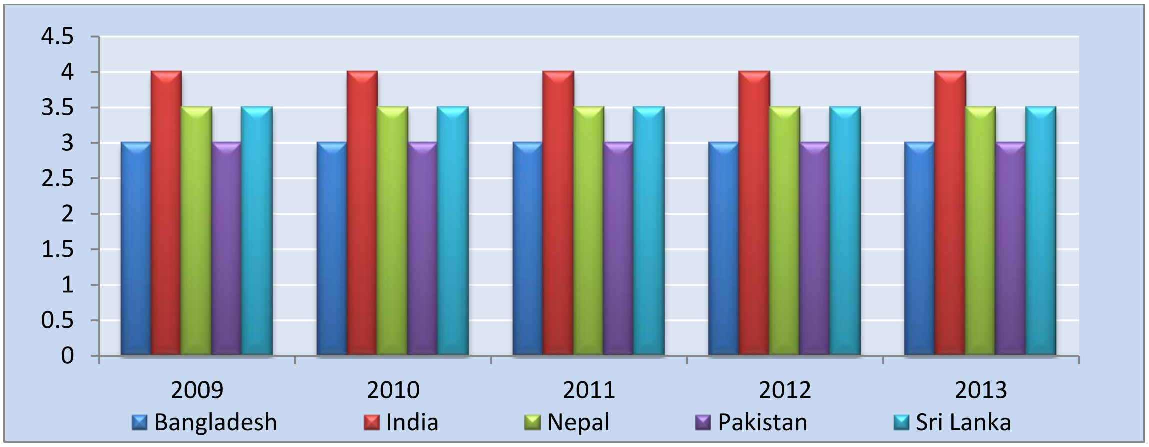


Source: PRI Staff calculations

Despite the marginal improvement, tax effort indices for both direct and indirect taxes are quite low, implying that Bangladesh has substantial untapped potential for raising revenue collection from both the categories of taxes.

Another important feature of Bangladesh's tax systems is higher inefficiency, especially in tax administration. Figure 15 below shows that Bangladesh and Pakistan has one of the lowest efficiency score among the South Asian countries. Furthermore, no improvement was reported between 2009 and 2013.

Figure 15: CPIA efficiency of revenue mobilization rating (1=low to 6=high)



Source: WDI, World Bank Databank

Except for the introduction of VAT in 1991, most of the reform measures were piecemeal and often ad-hoc in nature. There has been a growing realization that Bangladesh needs to implement further tax reforms and modernization of tax administration to address structural and institutional deficiencies in the current tax system. Coordinated reforms, underpinned by strong political support will be essential for making Bangladesh's tax system more efficient and more revenue productive in a sustainable manner.

III. Fiscal Objectives/Targets under the SFYP and Plan Realization

A review of fiscal performance under the SFYP indicates that during the first four years of the Plan the structural characteristics of Bangladesh fiscal policy have changed, albeit quite modestly. As in the past, expenditure growth, including spending on social programs, continued to suffer from limited resource allocation. Ambitious targets to boost NBR revenue only resulted in limited success. It only proved that in the absence of fundamental reforms in the VAT and Direct Tax systems (including tax administration), discretionary revenue measures only yielded limited revenue gains in relation to GDP and the gains were not sustained.

A) Fiscal Deficit and Financing:

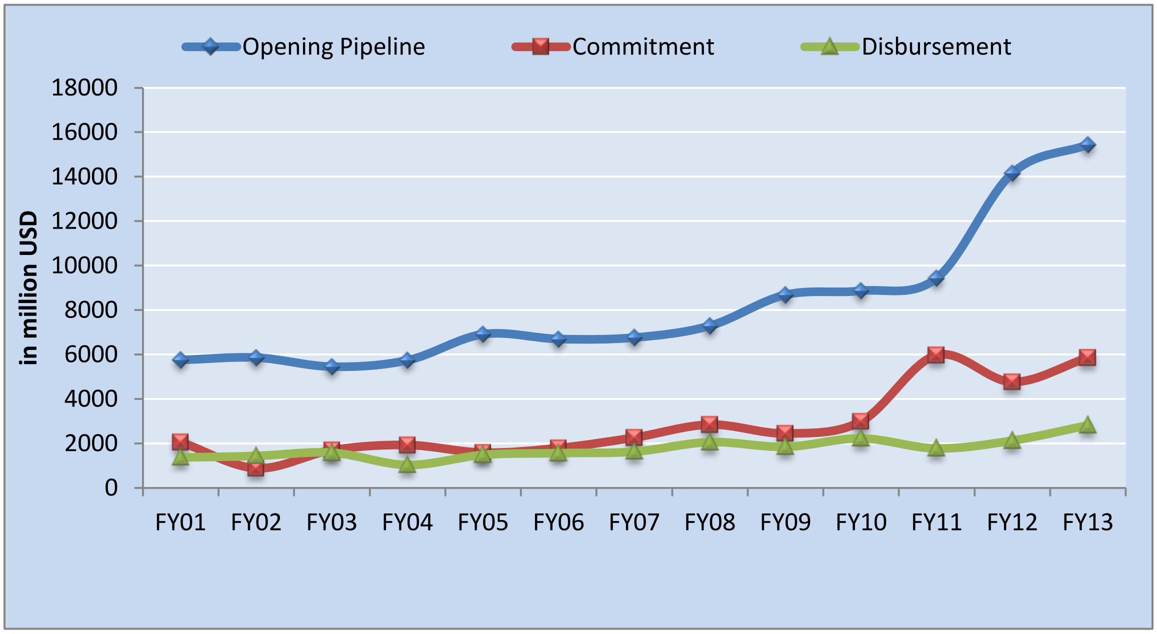
Table 7: Deficit and Financing-SFYP Targets and Actual												
	FY11		FY12		FY13		FY14		FY15		Average(FY11-15)	
As % of GDP	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual
Fiscal Deficit	-3.9	-4.2	-4.5	-4.1	-4.4	-4.4	-4.5	-4.1	-4.5	-5.0	-4.4	-4.4
Domestic Financing	3.1	3.9	3	3.4	3	3.2	3	3.6	3	3.2	3	3.5
Foreign Financing	1.3	0.3	2	0.8	2	2.0	2	0.5	2	1.8	1.8	1.1

Source: SFYP Documents and Ministry of Finance

When compared to the overall fiscal deficit targets set in the SFYP (Table 7), Bangladesh has done very well in maintaining the deficit levels very close to the SFYP targets or even below. Therefore, the average deficit targets and actual average outturns during the Plan period were exactly the same. This is a commendable performance since this demonstrates that the fiscal management efficiency of the government has improved in line with the Plan.

In terms of financing of the fiscal deficit, there have been significant deviations between domestic and external financing mix as set out in the Plan and the actual performance. While the Plan aimed at financing at least 45% of the deficit through external sources, in most years during the Plan period external financing accounted for below 20% of the deficit, except for FY13. The flow of external financing has been erratic reflecting the weaknesses in institutional capacity of the government in utilizing the foreign aid commitments (Figure 16). Reflecting this capacity constraint, the average external financing (net) in relation to GDP for the Plan period stood at only 1.1% in comparison to the Plan target of 1.8% of GDP. The government seems confident in its ability to secure 36% of deficit financing through external sources in FY15, however once again the outcome would depend on the capacity of line ministries in utilizing the external resources already in pipeline.

Figure 16: Foreign Aid-Pipeline, Commitment and Disbursement



Source: ERD, Flow of External Resources

One of the main downsides of low utilization of external finance is the increased pressure on domestic borrowing for financing of the fiscal deficit, especially from the banking system. As there were sizable shortfalls in foreign financing, the deficits were covered from domestic sources. The average domestically sourced financing for the Plan period was 3.5% of GDP in contrast to the target of 3% of GDP. This increased dependence on bank financing needs to be curbed since at certain times, particularly in FY11-12 such high borrowing led to crowding out of the credit available for private sector investment and businesses. It is also ironic that despite a huge and rapidly bulging foreign aid pipeline (Figure 16), Bangladesh could not utilize even the relatively modest levels envisaged under the SFYP.

B) Expenditure scenario:

Table 8: Expenditure- SFYP Targets and Actual

	FY11		**FY12**		**FY13**		**FY14**		**FY15**		**Average(FY11-15)**	
As % of GDP	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual
Total Expenditures	16.5	14.9	18.2	16.3	18.4	16.7	19	18.3	19.6	18.7	18.3	17.0
Current Expenditures	9.8	10.7	9.8	11.2	10.3	10.7	10.5	9.4	10.8	9.6	10.3	10.3
ADP (PPP + Public entities)	4.5	4.2	5.1	4.1	5.3	4.8	5.7	5.1	6.1	6.0	5.3	4.8
Others Expenditures	2.2	1.9	3.3	2.5	2.8	2.1	2.8	3.0	2.7	3.0	2.7	2.5

Source: SFYP Documents and Ministry of Finance

One of the main drivers of government expenditure is the revenue performance, which ultimately accounts for a substantial portion of the government budget. The revenue performance in the

SFYP period was mostly below the targets set under the Plan, resultantly the expenditure also fell below target. As is evident from Table 8 above, the total expenditure as percentage of GDP was persistently below the SFYP targets, averaging 17% of GDP against a target of 18.3%. The shortfall was mainly contributed to by the shortfalls in ADP expenditure, since current expenditure was on target. Current expenditure exceeded the Plan targets in the first three years of the plan period, and only fell short in FY14 and expected to be below target in FY15 budget. As a result of this, the average current expenditure for FY11-FY15 is expected to stand at 10.3% of GDP which is exactly as set out in the plan.

The increase in current expenditure over the plan period is nothing to rejoice over since it adds no value to the development or growth of the economy and indicates inefficiency in cost management on the part of the government. A closer look at the components on current expenditure targets and actual performance in the plan period reveals that the main drivers of this increase were interest payments and subsidies of the government (Table 9). The interest payment expenses of the government were higher than the plan targets for FY11-FY14. The provision made in the budget for FY15 for interest payments also exceeded the SFYP target for FY15. This increase was mainly due to increased reliance on high interest domestic borrowing including nonbank borrowing in the form of domestic saving instruments discussed previously. As discussed earlier, subsidy payments increased rapidly exceeding amounts envisaged under the SFYP. Subsidies constitute a huge deadweight expenditure for the government and needs to be reigned in to increase funds available for more pressing needs.

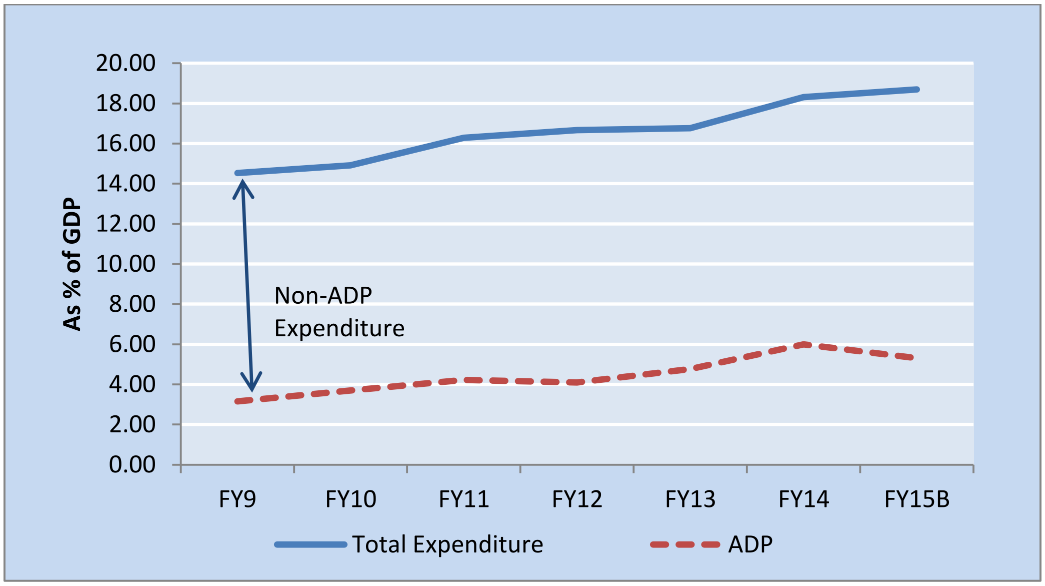
Table 9: Current Expenditure-SFYP Targets and Actual

	FY11		**FY12**		**FY13**		**FY14**		**FY15**		**Average(FY11-15)**	
As % of GDP	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual
Current Expenditure	9.8	10.7	9.8	11.2	10.3	10.7	10.5	9.4	10.8	9.6	10.3	10.3
Pay and Allowances	2.6	2.6	2.6	2.4	2.7	2.2	2.7	2.2	2.8	2.1	2.7	2.3
Goods and services	1.4	1.4	1.3	1.3	1.4	1.3	1.4	1.3	1.5	1.2	1.4	1.3
Interest Payments	1.9	1.9	2	2.2	1.9	2.2	2	2.3	2	2.3	2	2.2
Subsidies	3.9	4.1	3.9	4.1	4	4.1	4.1	3.5	4.2	3.7	4	3.9
Block Allocations	0	0.1	0	0.1	0.3	0.0	0.3	0.0	0.3	0.1	0.2	0.1

Source: SFYP Documents and Ministry of Finance

B) (i) **Annual Development Program (ADP)** – A major change we observe is on the size of Annual Development Plan (ADP) spending. Certainly, the government has been successful in increasing the size of ADP by allocating most of the increased budgetary resources (in terms of GDP) to the expansion of project spending (Figure 17). ADP implementation rates also increased markedly over this period.

Figure 17: Total Expenditure and Components

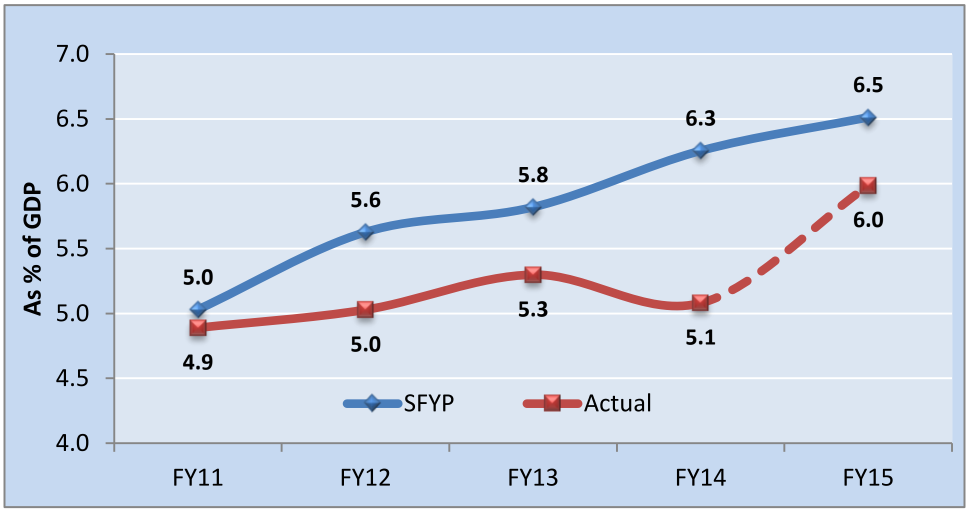


Source: Ministry of Finance, Budget Documents

However, in the absence of adequate monitoring and evaluation by the government at the implementation stage and due to governance problems in administering the projects, the gains from this significant increase in public spending on ADP were not visible in terms of catalyzing private sector investment and output. As a matter of fact, the Incremental Capital Output Ratio (ICOR) has deteriorated in recent years indicating unproductive nature of such public investment. Despite the significant increase in ADP, infrastructure gaps widened over the years. In the areas of major national transportation arteries (like Dhaka Chittagong, Dhaka-Mymensingh and Dhaka-Tangail Highways, and dual lines all through Dhaka Chittagong railways), major urban transportation projects (like Dhaka elevated metro rail, Elevated Expressway, Dhaka Bypass and second container ports), major bridges (like Padma Bridge, second Jamuna Railway Bridge, etc.) actual work was delayed significantly and most of them did not even start. Major electricity generation projects are still at planning/funding stages while the high-cost rental power plants are meeting the power needs of the economy on a temporary basis. The infrastructure challenges are enormous and seriously constraining growth. The cost to the economy will be enormous in terms of missed growth opportunities, if not attended urgently.

Figure 18 below shows that actual ADP allocation has been persistently below the targets set in the SFYP, and the gap between the two seems to be widening every year during the Plan period. The gap was highest in FY14, when political disturbances, problems with the World Bank on financing of Padma Bridge, and financial resource constraints contributed to the slowdown in implementation of the development programs of the government. Additionally, the ADP utilization every year indicated the inefficiencies that plagued the development projects leading to downward revisions in the ADP size every year and also a corresponding reduction in disbursement of foreign aid. The fact that PPP type projects did not get off the ground at all despite many announcements at the government levels also contributed to this shortfall. In FY15 budget, the government has set a very ambitious ADP target and it remains to be seen whether the gap with the SFYP target will really decline in reality or manage to widen them further.

Figure 18: ADP Allocation-SFYP Targets & Actual

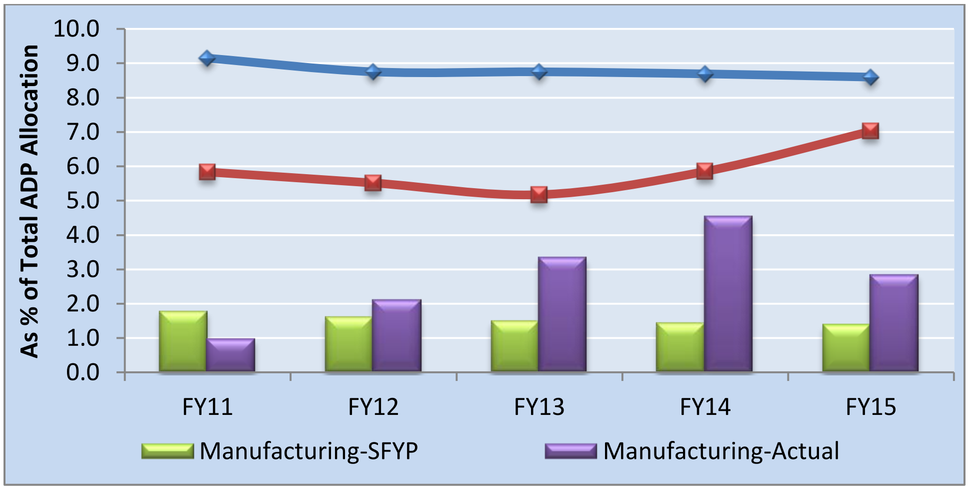


Source: Sixth Five Year Plan documents, Ministry of Finance

The sectoral allocation of ADP in the SFYP and actual performance comparison reveals the main avenues which contributed to the shortfall in overall ADP allocation. The main sector recipients of the ADP were: **Agriculture, Manufacturing, Transport, Energy, Education and Health**.

B) i) 1.1) ***Agriculture and Manufacturing***: Since Bangladesh is still an agrarian economy; the importance of the agriculture sector remains paramount. Achievement in food self sufficiency has been achieved in recent years owing to the channeling of funds to the sector and supporting the farmers through agricultural input subsidy. However, as is evident in the Figure 19 below, the total ADP allocation for the sector has been persistently below the targets set out in the SFYP. The allocation was expected to be well above 8.5% of total ADP throughout the plan period, whereas the actual allocation till FY14 was below 6% of total ADP. In contrast, the allocations for the manufacturing sector have persistently exceeded their targets throughout the Plan period. While the Plan allocated just about 1.5% of total ADP to the sector, the actual allocation has gone up to 4.5% in FY14 having increased consistently since FY11. This clearly indicates that the government strategy was misplaced. While the Plan envisaged that the government should move away from being involved in manufacturing activity, in reality the government tried to support public sector manufacturing entities to sustain and expand production even though most of them are very inefficient. Under a private sector led growth strategy, government entities should move out of such activities (like manufacturing) which are much better performed by the private sector.

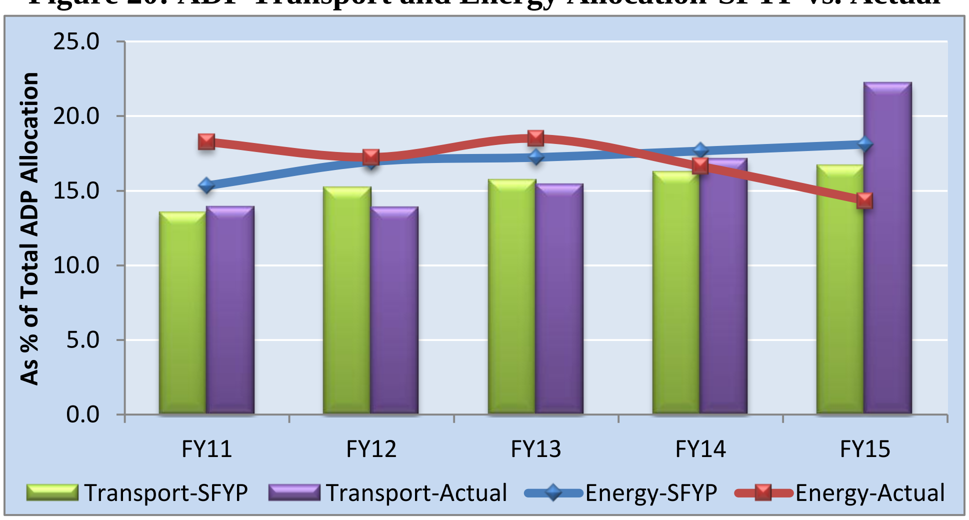
Figure 19: ADP Agriculture and Manufacturing Allocation-SFYP vs. Actual



Source: Sixth Five Year Plan documents, Ministry of Finance

B) i) 1.2) *Transport and Energy*: The energy sector allocation of ADP has been erratic, with allocations being high in FY11 and FY13, and declining during the other years in the plan period (Figure 20). The recent deceleration in allocation for the energy sector is a cause for concern, since Bangladesh still faces acute shortage of power which affects its industrialization efforts and the daily lives of its citizens adversely. The transport sector allocation as percentage of total ADP allocation has been mostly consistent with the SFYP targets in the first three years of the plan period but gained momentum in FY14 and FY15 owing to the increased allocation for the Padma Bridge. Overall, transport sector allocations have been broadly in line with the importance attached to the sector. However, major transport projects like Dhaka-Chittagong four lane and Dhaka-Mymensingh 4 lane projects are still far from completion and work on Padma Bridge is just at the mobilization stage.

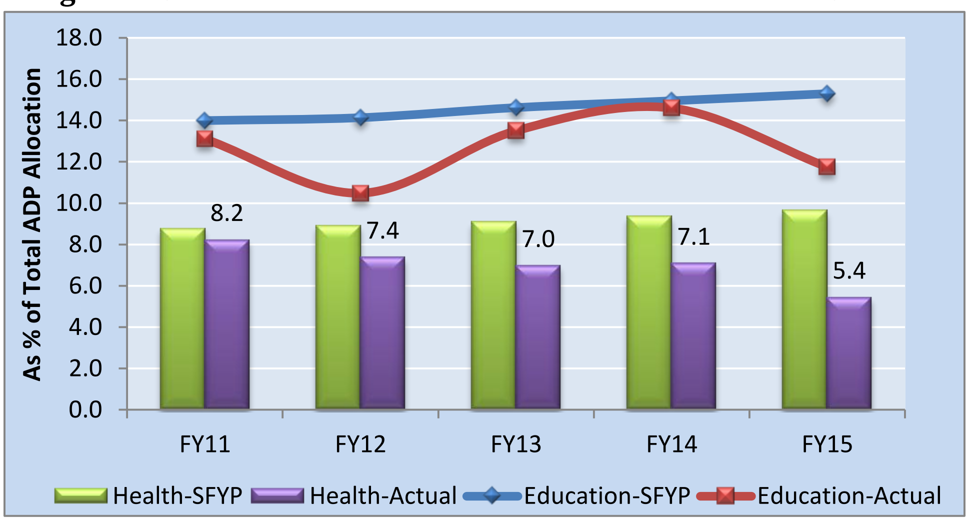
Figure 20: ADP Transport and Energy Allocation-SFYP vs. Actual



Source: Sixth Five Year Plan documents, Ministry of Finance

B) i) 1.3*) Health and Education*: Education has been a priority of the current government and has been part of their election manifesto over the years. However, allocation for the education sector has been below the SFYP targets in most years except for FY14 (Figure 21). It is alarming to see that the allocation for education as percent of total ADP allocation has in fact declined in FY15 budget in comparison to FY13 and FY14. While the government has achieved success in promoting education access and participation, allocation to the sector must continue to rise in order to improve educational quality, sustain that for the future generations, and develop the human capital of the country. Another cause for concern is the persistent shortfall in allocations to the health sector in comparison to SFYP targets. Healthcare expenditure has been declining since FY11 from 8.2% of total ADP allocation to as low as 5.4% in FY15. This is a matter of concern since the healthcare services and coverage available in Bangladesh are far from being adequate for the population. There is dire need for improvements in the medical staff, services and infrastructure since a huge portion of population is still deprived from basic medical care and modern medicine.

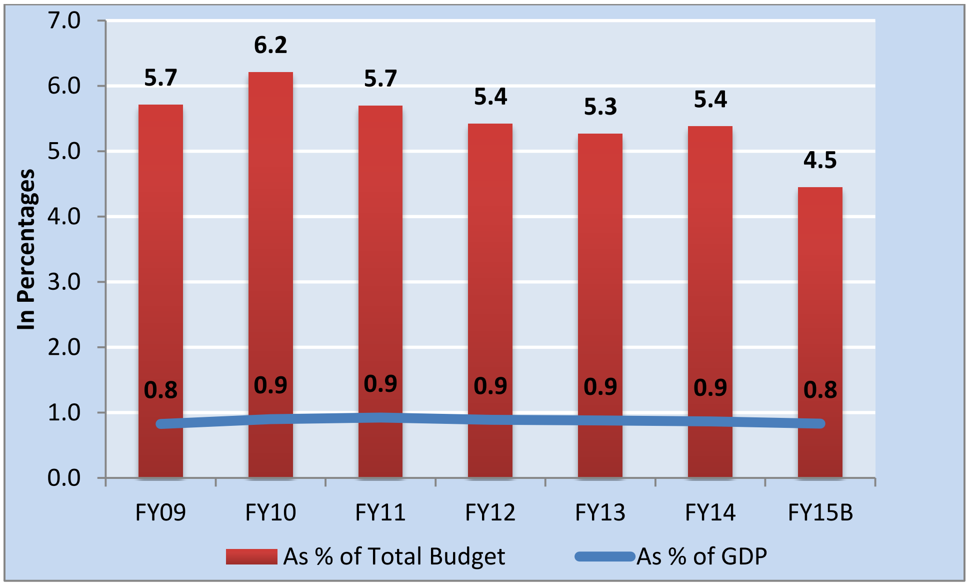
Figure 21: ADP Health and Education Allocation-SFYP vs. Actual



Source: Sixth Five Year Plan documents, Ministry of Finance

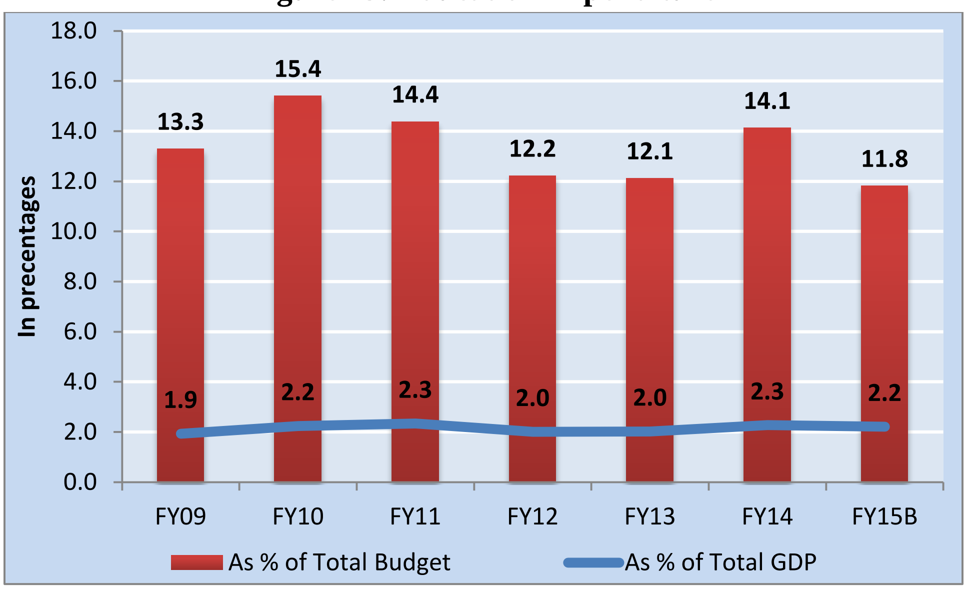
The government's track record in terms public resource allocation on social programs like education and health has been poor. Expenditures on education and health has remained either stable or declined in relation to GDP and certainly declined in relation to total budgetary expenditure. (Figures 22 and 23)

Figure 22: Healthcare Expenditure



Source: Ministry of Finance, IMED

Figure 23: Education Expenditure

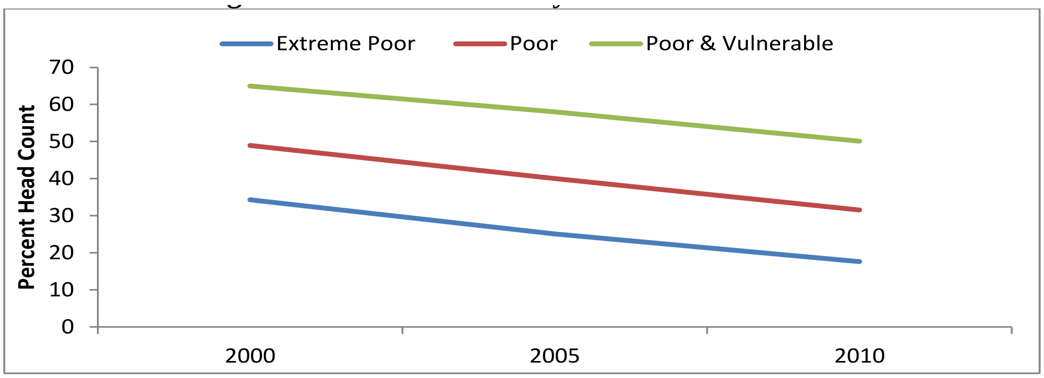


Source: Ministry of Finance

The fact that social sector spending under the plan could not increase in line with the Plan targets was primarily due to shortfalls in total and recurrent expenditures throughout the Plan period. The total expenditure targets set under the SFYP entailed a steady upward increase of more than 3 percentage points from 16.5% of GDP in FY11 to 19.6% of GDP in FY15. Actual expenditure of the government however did not follow this trend and fell short of the end-year target, even if we use the FY15 total budgeted expenditure as actual. The average expenditure target for FY11-FY15 in the SFYP was set at 18.3% of GDP, while the actual average expenditure of the same period (taking into account the budgeted expenditure for FY15) would be 17% of GDP. The shortfall in recurrent outlays—which include social sector spending on education, health, social protection etc.—fell short of the Plan target by 0.5 percentage point per year to 1% of GDP.

B) ii) Poverty reduction has been the hallmark of Bangladesh's social progress. It seems that poverty alleviation has mostly happened due to economic growth driven by RMG based manufacturing activity with very high labor intensity and the flow of remittance money from the unskilled workers working in the Gulf countries and Malaysia which directly help the poor households in improving their living standards. Government's social protection spending through about 100 separate programs amounts to about 1.6% of GDP (excluding pension payments to government employees) per annum, which is much less than the 11%-12% of GDP per annum in remittance income of which 70-80% goes to poor families. The employment effect of the $25 billion RMG sector, with 50% value addition on average and 70%-80% of the value addition going to poor workers (mostly female) have had a very significant impact on income generation by the poor landless families. Through absorption of workers in the RMG sector, this sector has also contributed to the decline in the absolute number of rural farm workers and has helped increase real wage of farm and non-farm workers in recent years.

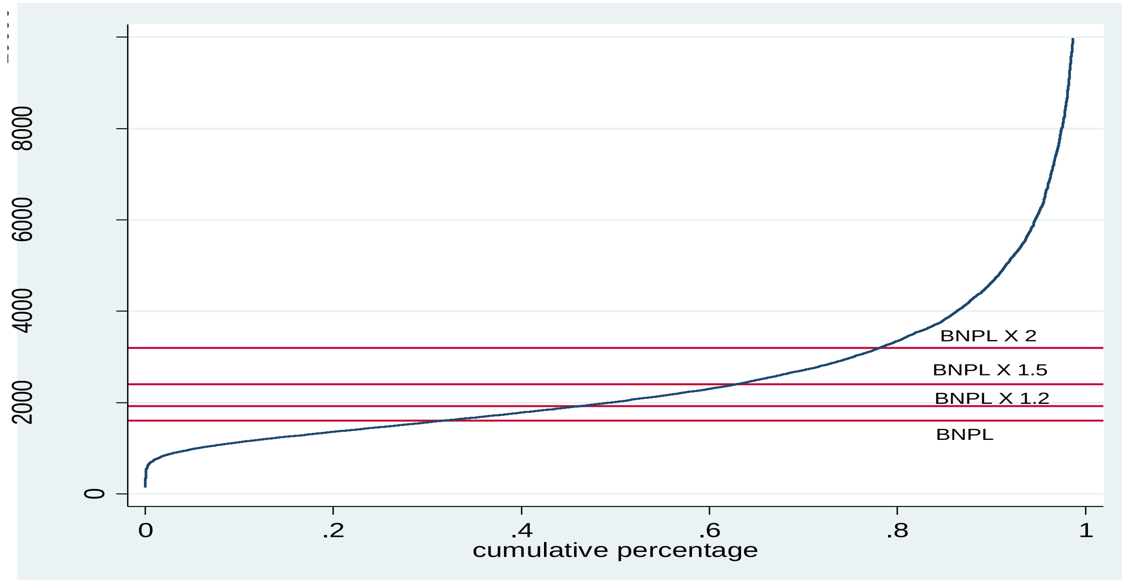
Figure 24: Trend in Poverty Reduction 2000 – 2010



Source: Bangladesh Bureau of Statistics, HIES 2000, 2005, 2010

The poverty level currently being used by Bangladesh (measured in terms of 2200 calorie intake equivalent in spending in taka terms) may not be used for measuring the poverty level once the country earns middle income status and marches to higher middle income status. Based on current HIES data (Figure 24), almost another 25%-30% of the population are near poor, living just above the poverty line. This large proportion of population is seriously vulnerable to poverty as they are likely to become poor with any significant economic and health shocks to these families and if the poverty line is adjusted upwards such as minimum income levels per person of $1.25 per day or $2.00 per day. Most of these near poor families are getting into and out of poverty depending on volatility of their income earnings or shocks to their income earning potential (prolong illness, flood, cyclone etc.).

Figure 25: Poor and Near-Poor Population



Source: HIES 2010

With 60% of the population at poor and near poor stage (if we use 1.5 times the Bangladesh National Poverty Line (BNPL) income), the fight against poverty is not going to be over anytime soon (Figure 25).

Against this background, an analysis of government spending on social sector programs indicate an uncomfortable outcome--a secular decline in the share of social spending as percent of total budgetary outlays in recent years. In all major categories of social spending like education, health and social protection we observe a steady decline in the level of spending relative to the total size of the budget. With spending on education and public health at about 2% of GDP and 0.7% of GDP, respectively, Bangladesh cannot expect to provide the quality of education and health care services that the citizen's of a middle income country would need. It will not be able to develop the skill level of its rapidly growing labor force and transform the demographic dividend into real acceleration of GDP and income growth.

Budgetary allocations for the social protection programs are also low at 1.6% of GDP (excluding expenditure on pensions for government employees). Moreover, this modest sum is also being distributed through about 100 social protection programs managed by more than 20 ministries/agencies with virtually no coordination among the executing ministries/agencies. Poverty impact of social protection programs was also limited and estimated to have contributed to only about 1.5 percentage point reduction in poverty. It is estimated that with a compressive reform of the social protection programs on a lifecycle basis would increase the impact social protection programs and help reduce poverty by about 5 percentage points (Table 10). The government has prepared a draft strategy for social security, which recommends a significant restructuring of the social protection spending for enhanced effectiveness and also to increase resource allocation in relation to GDP to put in place a comprehensive life-cycle based social security system in Bangladesh over the medium term in a phased manner.

Table 10: Poverty Impact of the Redefined Life Cycle Programs

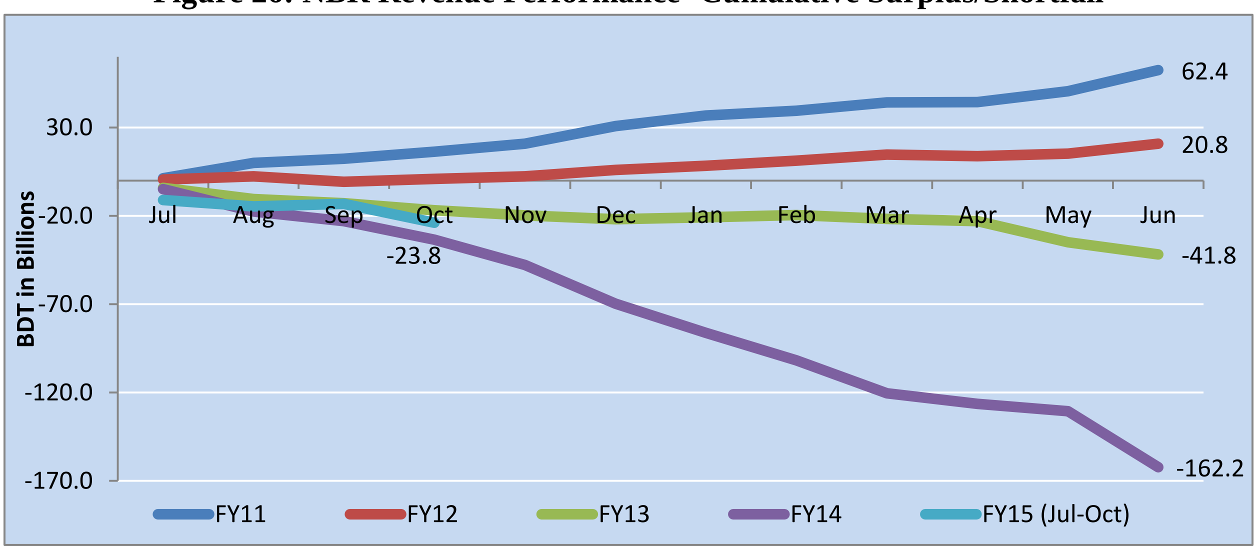
Simulation Type	Head Count Poverty (%)	Depth of Poverty (%)
No SSPs	33.0	7.4
Using 2010 SSPs reported in HIES	31.5	6.5
Using NSSS life-cycle programs	28.3	4.8

Source: NSSS Simulations using 2010 HIES data

C) Revenue Potentials and the Sources of Recent Revenue Growth:

Revenue performance from FY11-FY14 has been a story of extremes, with collections either exceeding targets or slowing down substantially. The main drivers of revenue growth have been domestic sources, mainly VAT domestic and income tax. Share of import-based revenue has been steadily decreasing as has been discussed earlier. The performance in the first two years during the plan period was very strong, with all major components and the total NBR revenue exceeding budget targets. However, this trend reversed in FY13 and FY14 when the country was plagued by political turmoil which considerably slowed down the pace of the economy. The trend reversal which started in FY13 gained momentum in FY14, which led to a larger shortfall in NBR revenue targets as shown in Figure 26 below. Despite the dismal performance in FY14, the NBR set an ambitious revenue target for FY15 which was 25% higher than the revenue collected for FY14. The performance of the first four months of FY15 does not show a very encouraging trend with revenue falling short of target each of these months, leading to a cumulative shortfall of BDT 23.8 billion at the end of October.

Figure 26: NBR Revenue Performance- Cumulative Surplus/Shortfall

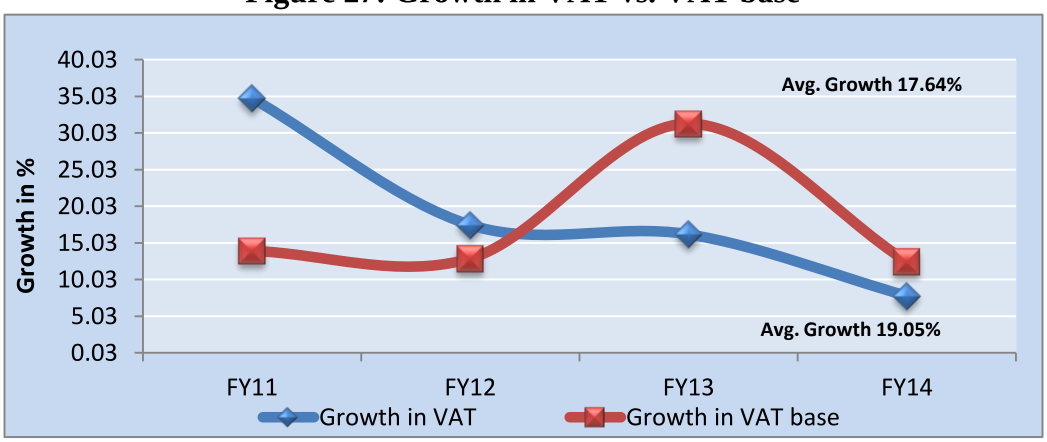


Source: NBR and PRI Staff Estimates

Both VAT and income tax performance exceeded their respective targets during the first 3 years of the plan period, despite the targets being quite ambitious. In fact in FY11 and FY12, income tax and VAT-domestic accounted for 55% and 84% respectively, of the total surplus in NBR revenue in these years. Even when NBR revenue declined in FY13 leading to a shortfall of BDT 41.8 billion, income tax and VAT-domestic exceeded their targets thereby reducing the overall shortfall.

A closer review of the strong NBR performance indicates that, in case of both domestic VAT and income tax, revenue collection exceeded their respective base expansion. In the case of VAT, which is a consumption type tax, the average rate of growth of consumption in nominal terms over the last 4 years was 17.6% compared with a much rapid growth in total VAT collection of 19.05% . Much of the VAT revenue growth came from domestic sources, which accounts for 63% of revenues from VAT. However, as is evident from Figure 27 below, the growth has been rapidly slowing down from a high of 35% in FY11 to 7.8% in FY14. Owing to its greater share, the rapid slowdown in growth in domestic VAT from 42% in FY11 to 11% in FY14 was the main contributor to the overall slowdown in VAT collection. Domestic VAT has experienced high growth performance since the introduction of VAT in FY92, when import stage VAT accounted for more than 73% of total VAT revenue. However, the economic slowdown leading to a dampening of consumer confidence in the last two fiscal years had a major dampening effect on this trend.

Figure 27: Growth in VAT vs. VAT base

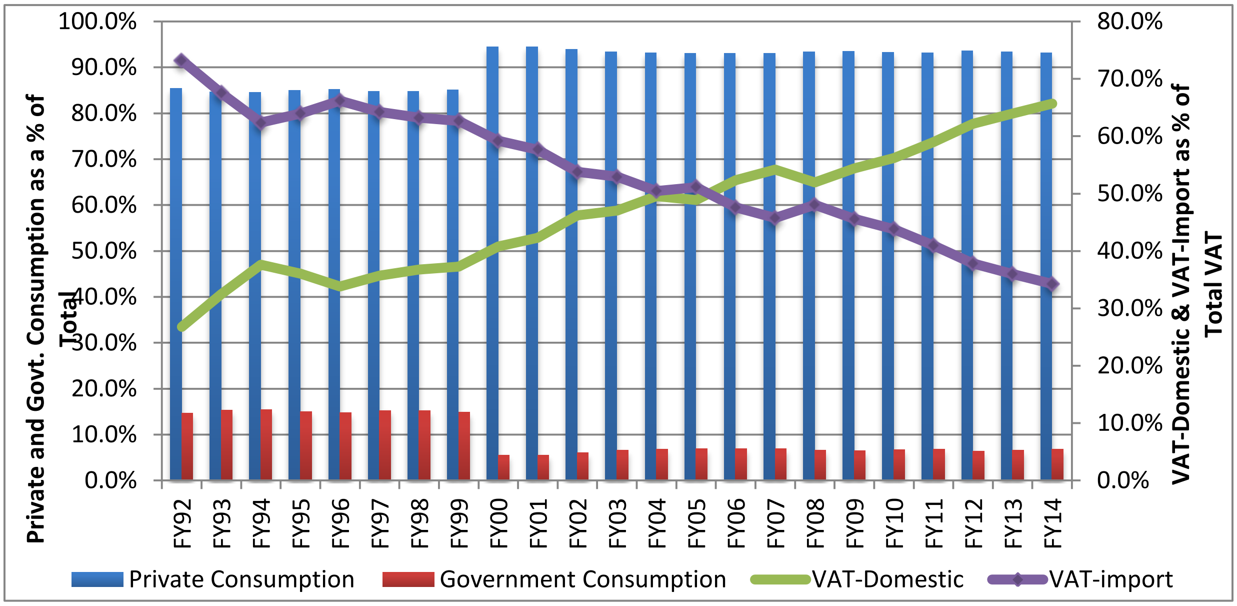


Source: National Accounts BBS, NBR

This shift in the composition of VAT revenue is a positive development. It shows that domestic consumption has been tilting towards domestic production and rendering of goods and services. Certainly, the steady expansion of domestic based VAT to wholesale, retail and service sectors have played important roles. The strong growth of key sectors like the newly emerged cell phone based telecommunications and the formal construction sector (real estate/housing industry), travel and transport, and the organized service sector (financial service providers, large hotels and restaurants). Another interesting phenomenon is the marked shift in consumption towards the private sector over the last two decades. Private consumption which accounted for

85.4% of total consumption in FY92 increased further to almost 93% of domestic consumption by FY14 (Figure 28). Since government consumption—mostly in the form of payroll—and government delivery of services (which constitute bulk of public services) are not subject to VAT, this shift in favor of private consumption has also worked in enhancing buoyancy in domestic VAT.

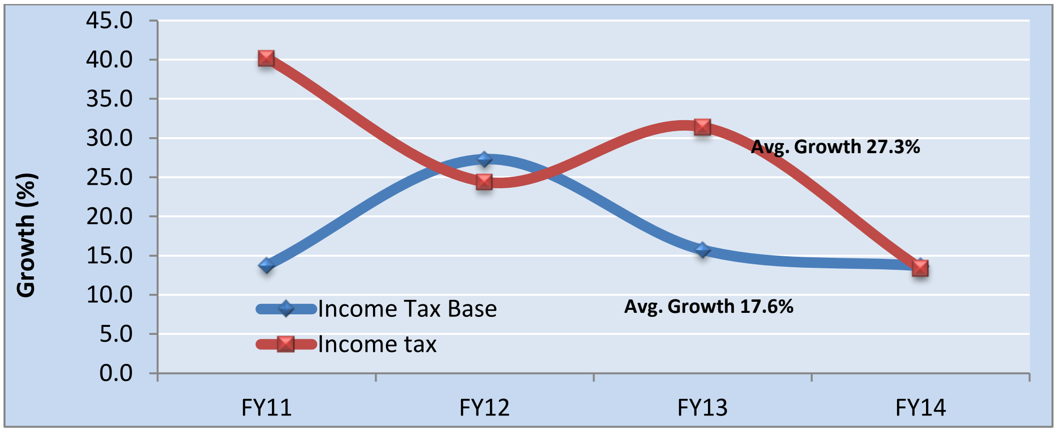
Figure 28: Consumption and VAT Pattern



Source: National Accounts BBS, NBR

On the income tax side also gains have been certainly made in relation to the tax base. Total income tax collection grew at an average annual rate of 27.3% during FY11-FY14, while the expansion (average growth rate) of the tax base during the corresponding period was 17.6% (Figure 29). Income tax growth rate slowed down considerably from 40.2% in FY11 to 13.4% in FY14. Expansion in income tax base started off at a low rate and gained momentum in FY12, and then continued to decline till FY14. The increase in income tax collection during this period suggests that there has been a healthy increase in the number of taxpayers as well as in withholding of taxes at source. While the corporate side of the income tax was impacted (negatively and positively) by developments in macroeconomic environment like the global economic crisis and the phenomenal surge in stock market prices inducing strong fluctuations in the performance of this component, personal income tax maintained its higher growth rates almost unhindered by market/external developments. Growth in corporate income tax slowed down to 11% in FY09 with the slowing of global and domestic economic activity, but performed very strongly in FY11 influenced in part by the stock market boom.

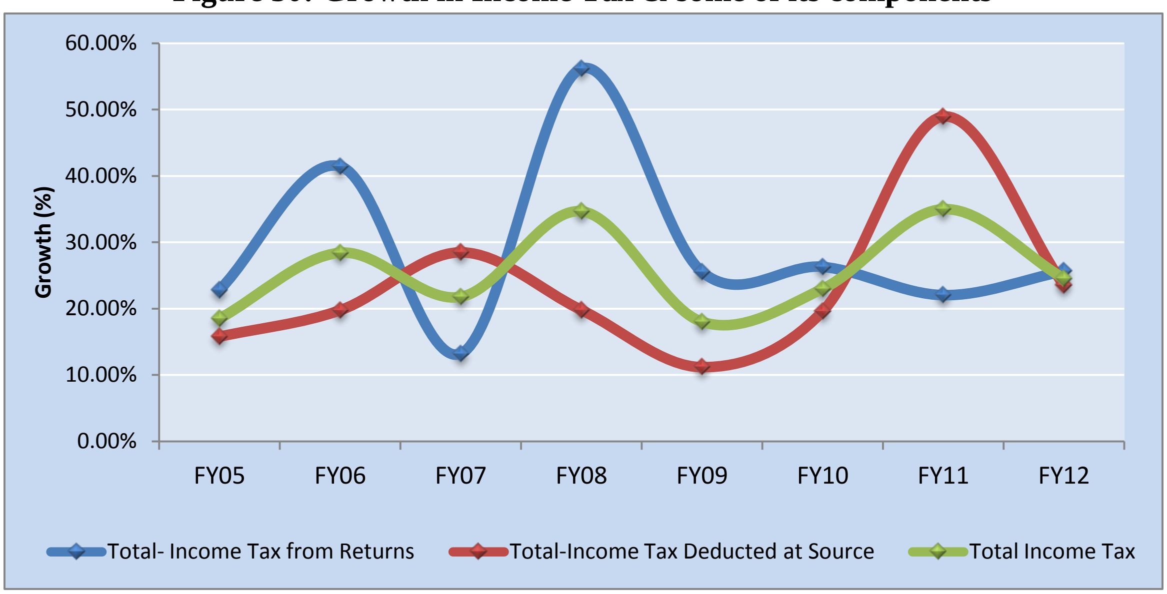
Figure 29: Growth in Income Tax Base and Income Tax



Source: National Accounts BBS, NBR

An examination of income tax collection process indicates that although revenue from income tax returns has gained more importance over time, income tax from source deduction has not gained momentum. Growth in income tax deducted at source surged sharply in FY11 reaching 49% only to nosedive in FY12 by almost half to 24% which is slightly above its average growth for the period of 19.5%, excluding the outliers. Income tax return submission has also grew steadily at around 24% excluding the outliers which shows that it has been steadily driving the total income tax growth.

Figure 30: Growth in Income Tax & some of its components



Source: NBR and PRI Staff Calculations

While the increase in tax payments through submission of returns is a welcome development, the slower growth in withholding at source indicates a fundamental weakness in direct tax administration and the current focus and inadequacies of the withholding measures. The structure of tax withholding in Bangladesh is very old-fashioned and does not indicate proactive management of tax withholding agents. However, in FY12 the withholding at source has been extended to twelve new sources, which does indicate that the list is being reviewed and the NBR is looking for potential sources from where additional revenue may be generated. Some of these new items are Royalty of Technical Know-how fee, Rental Power Company, Newspaper, Magazines, Privately-owned TV Channels, etc.

In most cases the NBR has relied on captive sources—using public offices (for contracts and supplies), financial institutions (withholding of interest and dividend income) and customs points (advance income tax from importers)--have been relied upon for collection of withholding tax. A careful review indicates that despite a decline in dependence in recent years, withholding from contractors on account of government supplies/projects accounts for 30% of total withholding in FY12. Withholding from at the level of imports from importers accounts for the second highest source of withholding (20%), followed by financial institutions on account of interest on savings, term deposits, security and treasury bonds of (17.3%) in FY12.

Table 11: Selected Components of Income Tax- Deducted at Source

BDT in Billions	FY07	FY08	FY09	FY10	FY11	FY12
Contractor/Supplier	**12.9**	**16.3**	**18.3**	**24.7**	**32.0**	**45.4**
Import of goods	**7.9**	**10.4**	**12.3**	**14.3**	**28.4**	**30.2**
Withholding from Financial Institutions:	**18.6**	**16.3**	**16.6**	**17.3**	**19.5**	**26.1**
Interest on Saving or Term Deposits	9.2	11.1	14.2	15.7	18.2	25.0
Interest on Security/Treasury Bond	9.1	4.4	1.9	1.4	0.9	0.8
Interest on Bank Deposit	0.2	0.7	0.1	0.0	0.0	0.0
Interest on treasury bond	0.1	0.0	0.4	0.1	0.5	0.3
Salary Income	**2.5**	**2.8**	**3.6**	**4.8**	**6.5**	**5.6**
Total-Income Tax Deducted at Source	**51.6**	**61.8**	**68.7**	**82.1**	**122.3**	**151.1**
As % of Total Income Tax Deducted at Source						
Contractor/Supplier	25.0	26.4	26.6	30.1	26.1	30.1
Import of goods	15.3	16.9	17.9	17.4	23.2	20.0
Withholding from Financial Institutions:	36.1	26.3	24.2	21.0	15.9	17.3
Salary Income	4.8	4.5	5.3	5.9	5.3	3.7

Source: NBR and PRI Staff Calculations

The unpleasant fact is that despite significant gains in recent years, withholding from salary income accounts for less than 6% of total withholding and in fact has further declined to 3.7% in FY12. This component registered the fastest growth (29%) during FY06-FY10, however since then its growth has decelerated. At only BDT 5.6 billion in 2012, it is relatively insignificant and falls well short of its potential. It is even more disturbing that out of this total, a staggering BDT 3.54 billion (63%) was withheld by the very few enterprises under the Large Taxpayers Unit (LTU) of the Direct Tax Department. The commissionerates reported very limited withholding on income from Doctors' fees (which may be easily doable through hospitals and clinics) despite clear legal provision in this regard.

Reflecting these administrative deficiencies, some of which may also originate from inadequacies in the tax laws, tax efficiency in Bangladesh has remained very low compared with its regional comparators. Given the 15% basic VAT tax rate, Bangladesh's current tax efficiency in VAT was only 0.25 in FY13, compared with much higher levels for its comparator countries. The story in terms of Bangladesh's direct tax efficiency is also similar. Although the gains recorded in recent years is encouraging, Bangladesh has a long way to go.

Table 12: Productivity of Tax Revenues among Asian Countries

Country	CIT Rate	PIT Rate	VAT rate	VAT Productivity(GDP Based)	PIT productivity	VAT Productivity(Consumption based)
Bangladesh	27.5	10 – 30	15	0.21	0.08	0.24
LIC Average				0.40	0.19	0.43
Nepal	25	15-35	13	0.46	0.12	0.39
India	30	10 -30	10	0.67	0.25	0.99
China	30	5 - 45	17	0.58	0.33	1.16
Thailand	30	10 - 37	7	0.70	0.26	1.63
Indonesia	30	5 - 20	10	0.45	0.19	0.67
Philippines	30	5 - 32	12	0.49	0.20	0.59
Korea	22	6 - 35	10	0.61	0.34	0.61
Sri Lanka	20	5 -35	15	0.46	0.15	0.36

Data Sources: PRI Estimates based on WEO (Data of 2011) of the IMF.

Note: Revenue productivities ratio of revenue collections as percent of GDP (or consumption, in the case of VAT) over the respective tax rate. Standard corporate tax rate used for income tax).

C) i) Revenue performance during the SFYP period

The revenue targets set under the Sixth Five Year Plan were not achieved, although the final outturn still depends on the performance in FY15. The target for NBR revenue in FY15 is very ambitious especially in light of the unsatisfactory performance in the last fiscal, which is weighing down the tax collection efforts. A comparison of the actual performance with targets set in the Sixth Plan is shown in the Table 13 below.

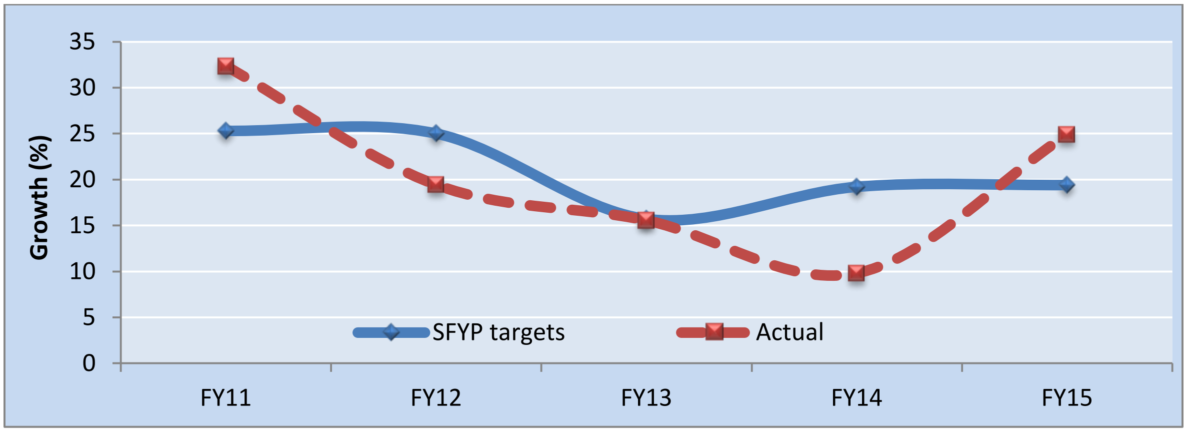
Table 13: Revenue-SFYP Targets and Actual

	FY11		FY12		FY13		FY14		FY15		Average(FY11-15)	
As % of GDP	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Actual	SFYP	Budget	SFYP	Actual
Total revenue	12.1	11.8	13	12.4	13	13.0	14	12.0	15	13.7	14	12.6
Tax revenue	10	10.1	11	10.4	11	11.0	12	10.5	12	11.6	11	10.7
NBR taxes	9.6	10.0	10	10.3	11	10.5	11	10.1	12	11.2	11	10.4
Non-tax revenue	2	1.7	2.5	2.0	2.2	2.2	2.2	2.1	2.2	2.1	2.2	2.0

Source: SFYP Documents and NBR

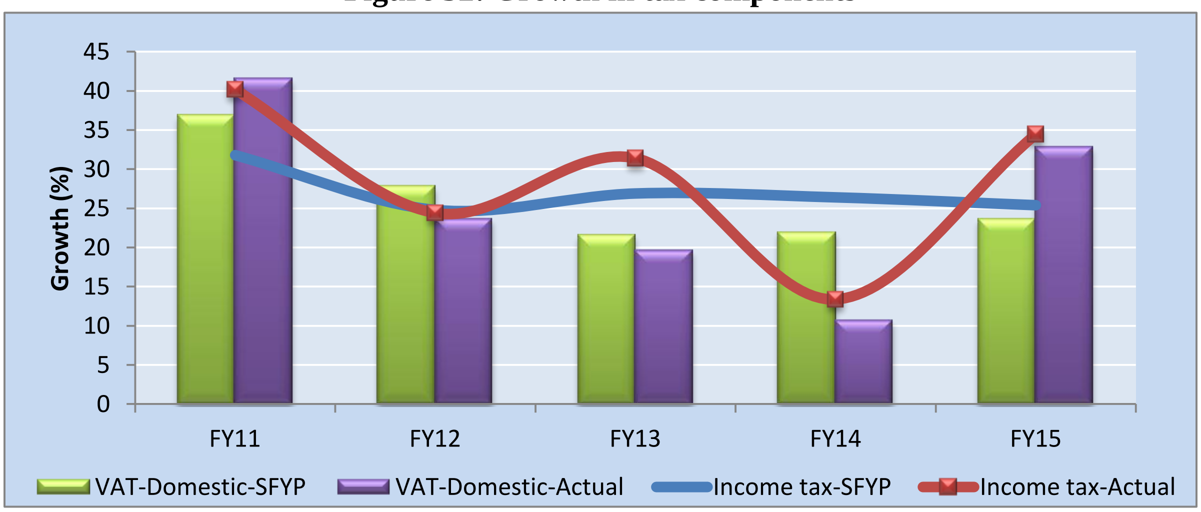
The total revenue target was not achieved in any of the years, in the plan period except for FY13, thereby leading to a five-year average of 12.6% of GDP in comparison to a target of 14%. The shortfall was mainly from the tax components, mainly NBR taxes, rather than the non-tax sources which were mostly in line with their targets. A closer look at the NBR revenue growth during the plan period shows that revenue collection exceeded targets in first two years of the plan period; however the momentum was lost in the subsequent two years (Figure 31). Despite having set a target of 11.2% of GDP in FY15, chances are low that the NBR will be able to achieve such an ambitious target.

Figure 31: NBR Revenue Growth



Source: SFYP Documents and NBR

Figure 32: Growth in tax components



Source: SFYP Documents and NBR

NBR revenue, income tax and VAT-domestic growth performance in comparison to SFYP targets has been erratic with actual growth exceeding and meeting target in alternate years, and falling short of targets in others (Figure 32). Growth of domestic VAT has been on a persistent decline since exceeding growth targets in FY11, which was partly due to non-implementation of necessary reforms. The growth targets of FY15 as set in the budget are higher than the SFYP targets, which is an unwise move since such a surge in revenue will not be experienced unless there is a massive rebound in economic activity in FY15. There is no sign of such a recovery until now.

IV. The Proposed Fiscal Strategy under the Seventh FYP

After a thorough analysis of the fiscal developments to date, we can conclusively state that the scope and breadth of any fiscal strategy of Bangladesh will depend on the revenue performance of the country. The government has shown considerable tact in adjusting expenditure and deficit in line with revenue performance and it is hoped that this managerial dexterity will be continued in the future. Improvement in revenue performance in turn will dependent on timely implementation of reforms in the VAT and direct tax systems and improvements in administrative efficiency of the NBR.

A) Revenue Performance under the SFYP and Seventh Five Year Plan Targets:

NBR revenue performance has been short of targets set in the SFYP, Perspective Plan as well as the Medium-Term Budget Framework of the government.

Table 14: Perspective Plan Targets and Actual (FY11-FY15)

As % of GDP	FY11		FY12		FY13		FY14		FY15	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Budget
Total Revenue	12.0	11.8	13.2	12.4	13.4	12.4	14.0	12.0	14.6	13.7
Tax	10.0	10.1	10.6	10.7	11.2	10.4	11.8	10.5	12.4	11.6
Non-Tax	2.0	1.7	2.5	2.0	2.2	2.1	2.2	2.1	2.2	2.1

Source: NBR and SFYP Documents

As described in section III)C)i) above, in the context of the SFYP, the revenue and tax targets set in the Perspective Plan of Bangladesh 2021 also were not achieved. The main sources of shortfall once again were from tax revenue sources, which slowed down since FY12 and have been lagging behind targets through FY14 (Table 14). Similarly, the government had also set some broad revenue targets in the Medium-Term Budget Framework (MTBF), which were also not observed in most cases (Table 15). The most recent MTBF provides official revenue projection through FY17, which shows the directional change in the sense what the government wants to achieve in the revenue composition of the country. The shift away from a greater reliance on indirect taxes to direct taxes, which means an increased effort to be made in income tax collection. A greater weight is also being put on domestic VAT which is at present one of the dominant sources of domestic-based revenue. And finally, the focus from import-based taxes is being shifted to domestic-based taxes, which again indicates a stronger domestic tax collection effort.

Table 15: MTBF Revenue Indicators and Actual Performance

	FY14	FY15	FY16	FY17	FY14	FY15
	Revised Target	Medium-Term Targets			Actual	Budget
Tax-GDP ratio	11	12.4	13.0	13.6	10.5	11.6
Ratio of direct to indirect taxes	36:64	35:65	36:64	37:63	36:64	36.4:63.5
Share of major taxes in total tax revenue						
Share of local VAT in total tax revenue	37.48	35.54	35.65	36.21	23	25
Cost of collection to total tax revenue	0.65	0.49	0.47	0.45		

Source: MTBF and NBR

Since the NBR revenue performance and hence the overall revenue performance have been below targets set under all the government plans, it will be unrealistic to assume that the future direction would be as charted in the existing Plans. The growth trajectory of tax revenue shows that growth in tax collection need to be significantly above 20% if the plan targets are to be achieved with extraordinary increases in collection required in FY15 to jumpstart the effort.

The tax revenue performance during the first four years of the SFYP was erratic and mostly below target. As discussed earlier, the slump in collection in FY14 makes the target for FY15 quite difficult to achieve, as is also evident from the performance of the first four months of the fiscal year. In the past, high growth years (in terms of revenue collection) such as FY08 and FY11-FY12, have coincided with years in which some tax reforms and tax measures were implemented. However, since the reform process was not sustained, the positive impacts have started to diminish in the years that followed. In FY11, some VAT and income tax reforms were implemented which led to the increase in tax collections surpassing the set targets. While the positive effects of these reforms continued until FY12 and some to FY13, because the new package of reforms was delayed the tax buoyancy started to diminish eventually leading to the slump in revenue collection experienced in FY14. The tax revenue growth rates from FY06-FY15 (July-October) are show in Table 16 below.

Table 16: Growth in Tax Revenue in Recent Years

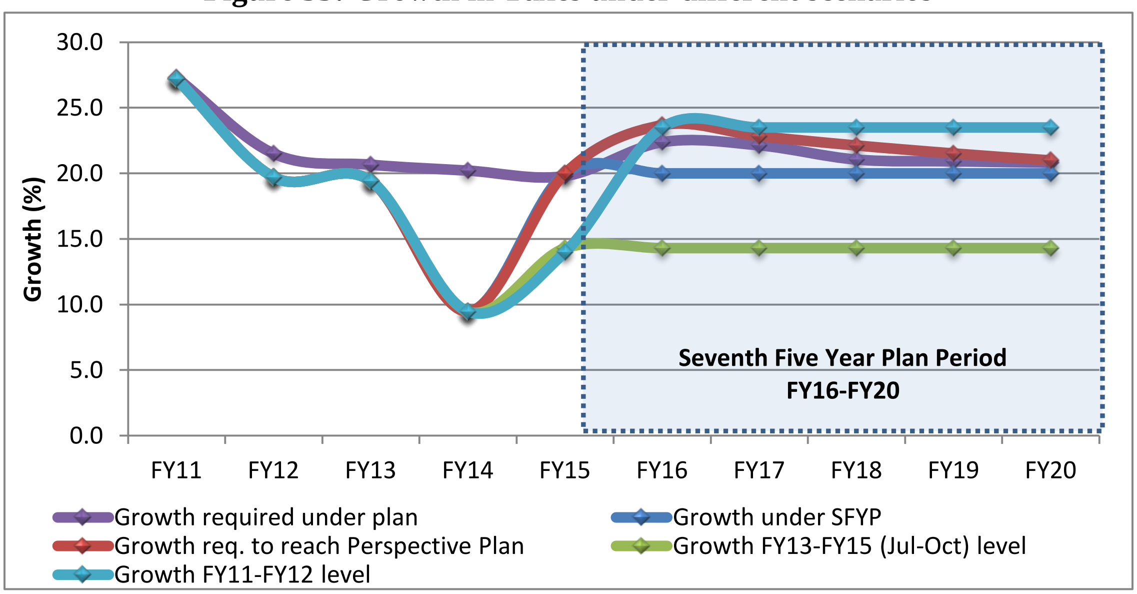
	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15 (July-Oct)
Tax Revenue Growth (in %)	12.3	10.6	27.7	10.8	13.4	27.2	19.7	19.4	9.5	14
Average Growth Rate	**15.0**					**23.5**		**14.3**		

Source: Estimates based on NBR data.

In light of these considerations, three growth scenarios are presented for the Seventh Five Year Plan period as shown in Figure 33 below which are based on growth trends recorded in different periods in the past. The average growth in tax revenue required to reach the Perspective Plan (from FY15-FY20) revenue targets would be 21.2%. However, since the performance in the last two years has been poor, the tax revenue will need to grow by 22.4% per year on average in order to reach FY20 revenue targets under the Perspective Plan. This is a tough target to achieve since tax revenues grew at an average of 23.5% only during FY11-FY12, and has sharply declined to an average of 14.3% during FY13-FY15 (July-October). On the assumption that 80% of the overambitious growth target for FY15 would be achieved, it would limit the SFYP actual average tax revenue growth rate at 20%. If this trend continues in the seventh five year plan period, the targets for the Perspective Plan will still not be achieved. Furthermore, the actual average growth rate from FY11-FY14 was 18% and a continuation of this trend in into the seventh plan period would further increase the shortfall in tax revenue performance from Perspective Plan levels. While the Perspective Plan sets a tax-GDP ratio of 16.6% by FY20, if revenue continues to grow at a respectable rate of 20% per annum, even then the tax-GDP ratio will stand at 14.7% of GDP by FY20, the final year of the Seventh Plan. It is also noteworthy, that in the most recent two fiscal years and in the first four months of FY15, the average growth in tax revenue has been only 14.3%. At this pace the tax-GDP ratio will remain at11% of GDP by FY20.

The required growth rates in tax revenue to achieve the targeted tax/GDP ratios also depend on the domestic GDP deflators or inflation rates. The scenarios presented here are based on the assumption that the domestic inflation rate will steadily decelerate to 5% by FY20. In the event the government tolerates a higher inflation target under the Seventh Plan, the required growth rates for tax revenues would be correspondingly higher.

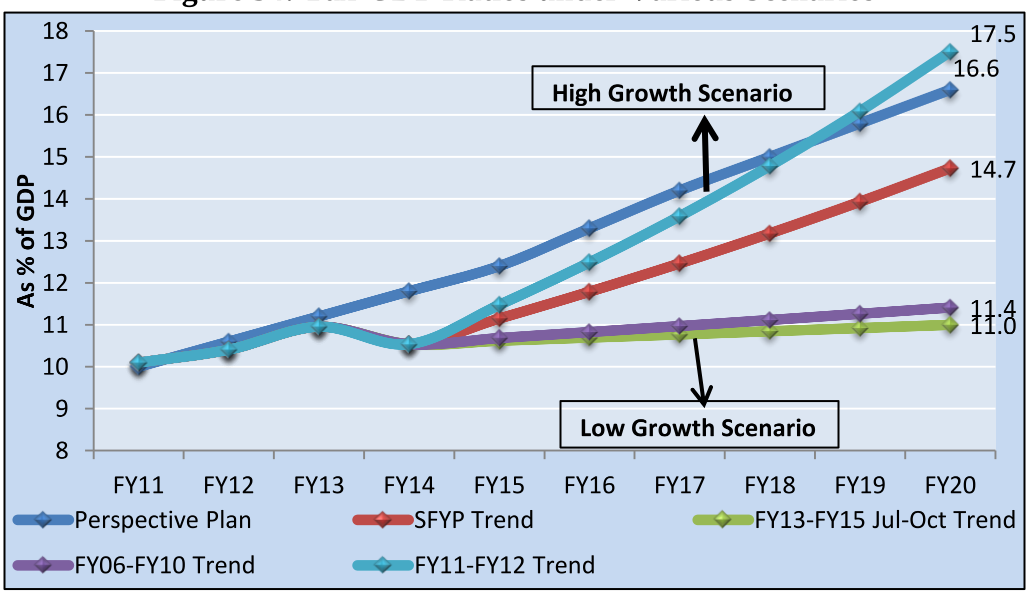
Figure 33: Growth in Taxes under different scenarios



Source: PRI Staff Calculations

In line with these growth scenarios, four possible tax-GDP scenarios are presented in Figure 34 below. These scenarios build a strong case for the need for tax reforms, particularly in the collection of domestic taxes which would constitute bulk of the revenue collection effort. FY13-FY15 (July-October) present a low growth scenario in tax revenue and therefore a continuation of this trend would result in the tax-GDP ratio stagnating at 11% of GDP. If there are no major reforms during the five year plan period, it would be safe to assume that tax revenue performance will fall back to the pre-SFYP (FY06-FY10) levels and thereby would result in a tax/ GDP ratio of 11.4% by FY20, much below the tax to GDP target of 16.6% envisaged under the Perspective Plan. On the realistic presumption that the FY15 targets would not be observed and total NBR revenue will be BDT 1493.8 billion compared with the budget target of BDT 1552.9 billion, on the assumption that the SFYP average growth performance of 20% is continued into the Seventh Plan period, the tax-GDP ratio would stand at 14.7% in FY20. Finally, the high growth scenario reminiscent of the FY11-FY12 period is the only scenario which would lead tax to GDP ratio to surpass the Perspective Plan targets during the seventh plan period and increase tax/GDP ratio to17.5% in FY20. Amongst all these scenarios, the most feasible trajectory seems to be that of the SFYP trend, since it is line with the performance of the more recent years and sets a growth target that is achievable while still setting an ambitious target. However, even under this scenario the necessary tax reforms would need to be implemented along with the improvements in efficiency of the tax administration for the target to be attained.

Figure 34: Tax-GDP Ratios under Various Scenarios



Source: PRI Staff Calculations

Based on the analysis presented above, we can set the revenue targets under the Seventh Five Year Plan as presented in Tables 17 and 18 below. In the last five years, NBR revenue constituted 96.5% of the total tax revenue which is expected to continue into the Seventh Plan period since, Non-NBR taxes has been stable accounting for about 3.5% of total tax revenue. Therefore the NBR revenue target should be set at 14.3% of GDP against a total tax revenue target of 14.7% of GDP at the end of the seventh five year plan period. The resultant total revenue target will be 16.2% of GDP, which is four percentage points higher than the 12% rate that has been achieved in FY14.

Table 17: Revenue Structure in the Seventh Five Year Plan Period (FY16-FY20)

	FY14	FY15		FY16	FY17	FY18	FY19	FY20
	Actual	Budget	Rev.Proj	7FYP Period				
Total Revenue	12.0	13.7	13.2	14.2	14.7	15.2	15.7	16.2
Total Tax Revenue	10.5	11.6	11.2	11.8	12.5	13.2	13.9	14.7
NBR Tax Revenue	10.2	11.2	10.8	11.4	12.1	12.8	13.5	14.3

Table 18: Major Components of Revenue under the Seventh Five Year Period (FY16-FY20)

	FY14	FY15		FY16	FY17	FY18	FY19	FY20
	Actual	Budget	Rev.Proj	7FYP Period				
Customs Duty	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3
VAT+SD	5.3	5.8	5.6	5.9	6.2	6.5	6.8	7.2
Income Tax	3.6	4.0	3.9	4.2	4.5	4.9	5.3	5.7
Others	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Non-NBR Tax	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Non-Tax Revenue	2.1	2.1	2.1	2.4	2.2	2.0	1.8	1.5

Source: PRI Staff Calculations

The composition of NBR revenue shows that the share of custom duty is expected to continue declining gradually from 12% of NBR revenue in FY14 to 9% by the end of FY20. The main sources of growth remain VAT and Income Tax which jointly are expected to account for 90% of total NBR revenue by FY20 from the FY14 level of 87%. VAT on the domestic level is expected to experience the highest growth during the seventh plan period and this growth could be further enhanced if the reforms under the VAT Act are implemented. The specific reform strategies and their results are discussed in the next section.

The Seventh Five Year Plan revenue projection presents an opportunity for Bangladesh to break out of the 12-13% of GDP level that it has been stuck in recent years. The need for strengthening of the tax administration, its computerization and improvement in efficiency is integral to achieving these targets. This is mainly because the crux of the growth would be derived from domestic sources, mainly income tax and VAT. Expansion of the income tax base and bringing more individuals and companies under the tax net and under the withholding mechanism would be necessary to drive the revenue growth and to achieve levels enjoyed by our neighboring countries. Since a major section of the Bangladesh economy still falls under the informal sector it is one of the main reasons behind the slow increase in the number income taxpayers as well as limiting the potential VAT collection. Initiatives and incentives by the government to formalize these activities would greatly enhance the tax potential on the domestic sides while making it possible to achieve the targets set under the Seventh Five Year Plan.

B) Expenditure Projection under the Seventh Five Year Plan

As has been discussed in section III) B) i) 1.3*)*, the expenditure trend of the government has been increasingly skewed towards physical infrastructure development while expenditure on social sector has been declining or remaining static. However, one of the key objectives of the government should be to achieve a balance in spending on social and physical infrastructure so as to develop the human capital as well as the infrastructure of the country. Keeping in mind these long term objectives, the following projection of expenditure for the seventh five year plan has been developed as shown in Table 19.

Table 19: Share of Major Components in Total Expenditure (in Percent)

	FY14	FY15		FY16	FY17	FY18	FY19	FY20
	Actual	Budget	Rev.Proj	7FYP Period				
Education	13.8	11.7	11.7	12.1	12.6	13.0	13.5	14.0
Health	5.2	4.4	4.4	4.7	4.9	5.1	5.3	5.5
Social Protection (Excluding Govt. Pension)	10.4	8.9	8.9	9.4	9.8	10.2	10.6	11.0
Capital Investment	32.5	30.2	30.2	31.1	32.1	33.0	34.0	35.0
General Service etc	26.0	23.6	23.6	24.1	24.5	25.0	25.5	26.0
Others	12.0	21.2	21.2	18.7	16.1	13.6	11.1	8.5
Total Social Infrastructure	**29.5**	**25.0**	**25.0**	**26.1**	**27.2**	**28.3**	**29.4**	**30.5**
Total Physical Infrastructure	**32.5**	**30.2**	**30.2**	**31.1**	**32.1**	**33.0**	**34.0**	**35.0**

Source: PRI Staff Calculations

Table 20: Total Expenditure and Major Components under Seventh Five Year Plan

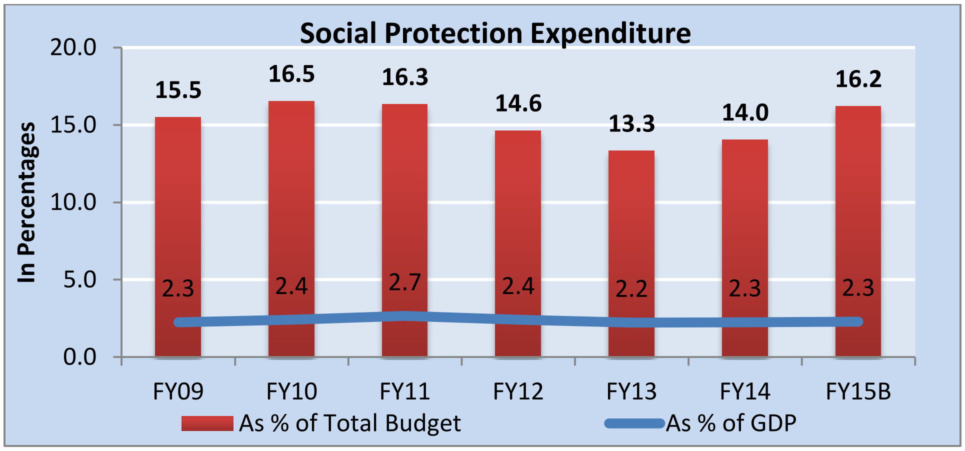
As % of GDP	FY14	FY15		FY16	FY17	FY18	FY19	FY20
	Actual	Budget	Rev.Proj	7FYP Period				
Total Expenditure	16.1	18.7	18.2	19.2	19.7	20.2	20.7	21.2
of which								
Education	2.2	2.2	2.1	2.3	2.5	2.6	2.8	3.0
Health	0.8	0.8	0.8	0.9	1.0	1.0	1.1	1.2
Social Protection (Excluding Govt. Pension)	1.7	1.7	1.6	1.8	1.9	2.1	2.2	2.3
Capital Investment	5.2	5.6	5.5	6.0	6.3	6.7	7.0	7.4
General Service etc	4.2	4.4	4.3	4.6	4.8	5.1	5.3	5.5
Others	1.9	4.0	3.9	3.6	3.2	2.7	2.3	1.8

Source: PRI Staff Calculations

B) i) Size of Government/Budget and Prioritization of Spending: Bangladesh has enormous fiscal challenges over the medium and long term. Demands from a rapidly growing middle income society for expanded public social services, social protection, and the massive unmet and new demand for infrastructure will be enormous. There is no option but to expand the size of the government relative to GDP and improve the quality of public spending on projects and public services.

ii) Social spending. The increased public resources would need to go primarily for improving: the quality of education for all nationals; better public health care facilities for the poor; and a life-cycle based social security/protection system for the poor. The declining trend in social expenditure in relation to GDP and as share of the total budget, as experienced in most of the SFYP period, must give way to a sustained higher resource allocation to social sector and social protection programs. (Figure 35)

Figure 35: Social Protection Expenditure



Source: Ministry of Finance

Bangladesh has to acknowledge the reality that a vast number of its citizens are below the poverty level and prepare itself for the renewed fight against poverty with a broader and stronger social protection/security program. The government has drafted a new Social Protection Strategy, which outlines the new direction that the government needs to move in the coming years based on a Life Cycle Approach to Social Protection/Security. The hallmarks of the new strategy will be the introduction of a rights based publicly funded Old Age Pension Plan for the Poor; all poor pregnant mothers receiving Pre- and Post-Natal Child Care for up to 4 years in order to ensure healthy future generation (free from stunting and mal-nutrition); all poor school going children receiving education stipend for attending primary and high school; training facility for the poor and abandoned women and widows. A phased implementation of this new strategy or something similar will require massive transformation of Bangladesh's social protection programs and increased budgetary resource allocation.

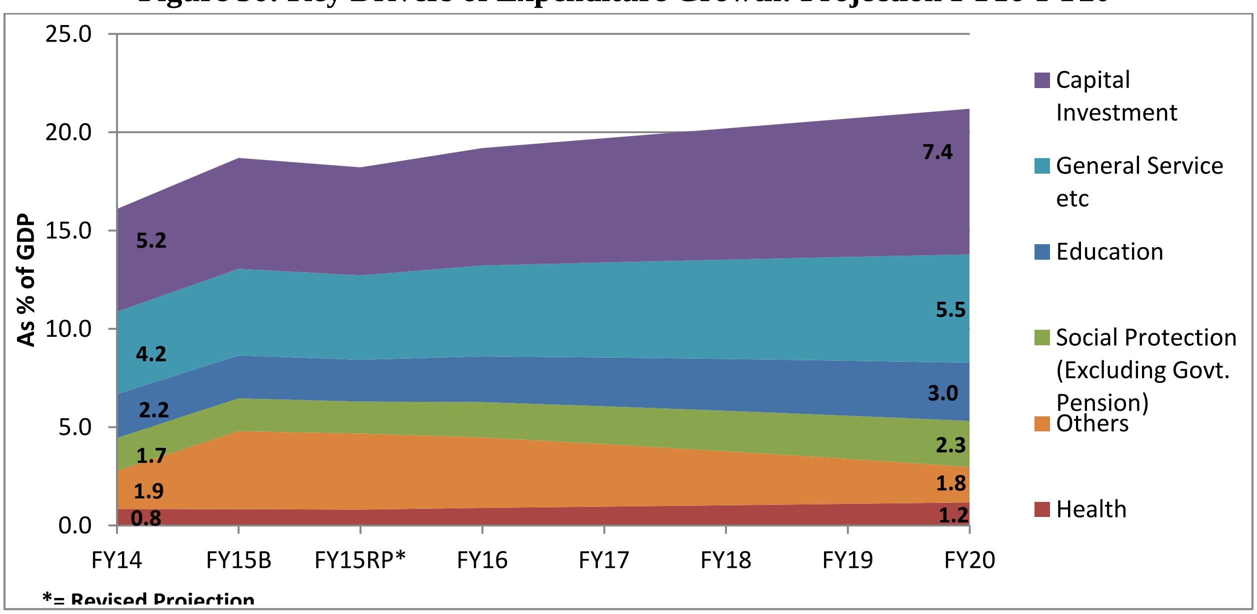
Expenditure on other major social programs like education and health would require significantly higher allocations in the longer run if Bangladesh wants to achieve 100% literacy rate with proper education up to the high school level (12 grades) for most of its children who will be joining the work force by 2021 and beyond. It also needs massive amounts of resources for skill development of the growing labor force.

All these spending plans will essentially entail that the budget size would probably need to increase to about 21.2% of GDP, a 4 percentage point increase in relation to GDP over the Seventh Five Year Plan period. The increase in spending in terms of GDP would need to be about 0.5-0.65 percentage point per annum. Such an increased in the size of the budget would allow for increasing the education budget by 0.8 percentage points to 3.0% of GDP, increase the public spending on health care by at least 0.4 percentage points to 1.2% of GDP, and spending on social welfare (excluding public pensions for the civil servants) by 0.6 percentage points to 2.3% of GDP. The social welfare spending target is in line targets set during the same period in the National Social Security Strategy. Altogether the additional demand from social spending side on the national budget would be about 1.8% of GDP and that would be a major challenge since there will be pressures from other sources like public investment.

iii) Investment Program. According to a World Bank study, Bangladesh needs about $9 billion (more than 5% of current GDP) in additional investment in major infrastructure projects per year to sustain growth at a higher level. Although government currently spends about 6% of GDP on ADP, one third of which is allocated for communications and power. This means current major infrastructure investment amounts to about $3-3.5 billion. Certainly, it would not be possible for the government to undertake such a major investment plan in infrastructure based entirely on budgetary resources. However, government resources need not cover the whole possible investment plan for today's fiscal strategy. The government would need to start its PPP initiative in full force to leverage public resources with private investment. With proper blending, public sector resource use could be limited to about 7-8% of GDP and still contribute to significantly improving the quality of infrastructure of Bangladesh.

With the type of structural transformations outlined above, expenditure side of the government budget would look more like the Figure 36 below.

Figure 36: Key Drivers of Expenditure Growth: Projection FY16-FY20



Source: PRI Staff Calculations

C) Fiscal Deficit and Financing

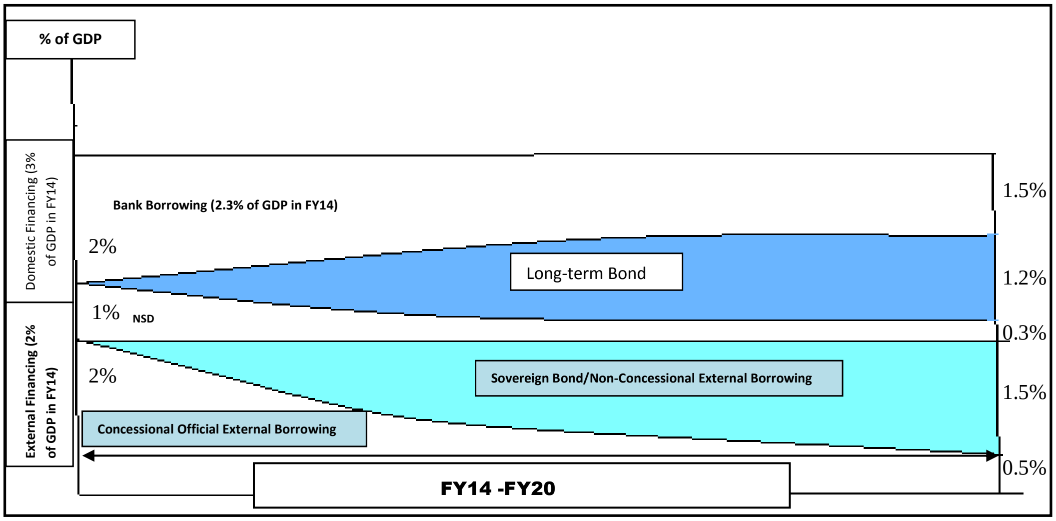
i) Deficit Financing and Its Composition: The government's fiscal deficit level should still remain at about 5% of GDP so that with 7%-8% GDP growth in the medium run there would be no question about debt sustainability. However, the government would need to diversify its sources of financing with proper mix of domestic and external financing, and on both fronts identify market based additional sources of financing. On the domestic borrowing front, dependence on National Savings Schemes and short-term treasury bills should give way to long-term treasury bills and bonds, infrastructure bonds, etc. with proper secondary market and a well-developed yield curve (which do not exist today). On the external front, the dependence on traditional concessional borrowing from official bilateral and multilateral sources should be increased and complemented with additional borrowings in the form of sovereign bonds of various maturities (with preference for longer maturity period as in the case of Indonesia and Philippines) and other sources of financing. Even with increased access to concessional finance its relative importance will decline over time as Bangladesh become a middle income country. The government should try to establish its relations with the international capital market by launching its first sovereign bond very soon because external and domestic conditions are favorable for such a launch. These strategic transformations should be done on the basis of a comprehensive Government Financing and Debt Management Strategy to be prepared by the Debt Management Wing of the Ministry of Finance. This scenario is summarized in Figure 37 below.

Table 21: Fiscal Deficit and Financing under Seventh Five Year Plan

As % of GDP	FY14	FY15		FY16	FY17	FY18	FY19	FY20
	Actual	Budget	Rev.Proj	7FYP Period				
Fiscal Deficit	-4.1	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Financing	4.1	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Domestic Borrowing	3.5	3.5	3.5	3.6	3.6	3.6	3.7	3.7
-Bank	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
-Non-Bank	0.9	1.0	1.0	1.1	1.1	1.1	1.2	1.2
External Borrowing	1.6	1.5	1.5	1.4	1.4	1.4	1.3	1.3

Source: PRI Staff Calculations based on NBR data.

Figure 37: Refocusing on Financing of the Deficit



Source: PRI Staff Projections based on the shifts envisaged under the Seventh Plan.

V. How to Realize the Revenue Targets for the Seventh FYP?

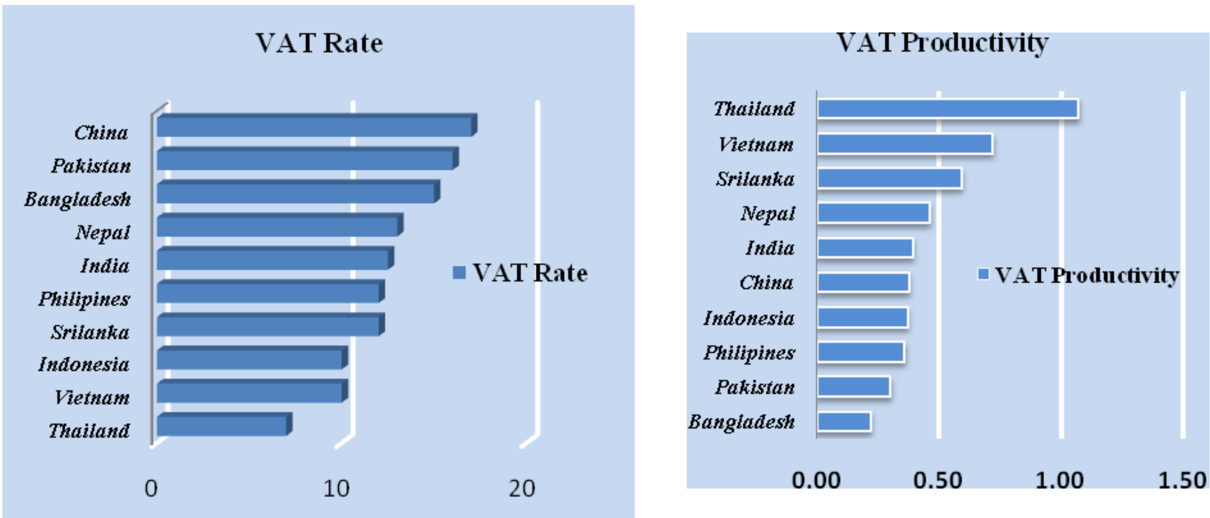
A) Revenue mobilization

The key challenge will be the government's ability to increase budgetary revenues to more than 16% of GDP from the current level of little more than 12% of GDP. The 4 percentage point increase in revenue in relation to GDP over a 5 year period, while ambitious in the Bangladesh context, is quite possible if we review the revenue performance of other developing countries. Many developing and most middle income countries have already done it and certainly Bangladesh can do it, despite its unimpressive track record on this front.

Complicating the task will be the other structural shift, which is already underway, entailing steady reduction in the share of customs duty with diminishing importance of trade-based taxes in line with global trend. The share of customs duty in total NBR taxes has already come down to about 12% of total NBR revenue, and this will probably decline further to about 9% of total NBR revenue by FY20. Accordingly, reliance of Direct Taxes and VAT would need to increase much more in relative terms. Every year revenue collection from these two sources would need to increase by 0.8 percentage point of GDP, shared roughly equally between the two major sources. The thing to remember is that, it has never happened in Bangladesh given its old-fashioned and out-dated tax administration. Beyond on-line registration for Taxpayer's Identification Number (TIN) nothing is automated at the NBR.

NBR has prepared a **NBR Modernization Plan** and presented that to Parliament at the time of FY12 budget presentation. The Modernization Plan has all the key ingredients of making the organization modern, efficient and capable of delivering the challenging the ambitious revenue targets that it needs to achieve. However, not much happened on that front except some progress on the VAT front in the context of IMF supported ECF program. The new VAT Act of 2012 is modern and the reformed VAT law should provide the legal basis for initiating a new era of VAT administration. However, this new law has to go hand in hand with a completely reformed VAT administration along functional lines and backed by modern IT based integrated business processes. Currently, Bangladesh VAT system is one of the most inefficient in the world with the lowest VAT productivity (Figure 38). This must change if we are to achieve the revenue objective in the long run.

Figure 38: VAT Rates and Productivity in Selected Countries



Source: Selected Issues, Fiscal Affairs, IMF, 2013.

i) On the VAT front, the NBR is preparing for such a change with support from the World Bank, IMF and IFC. If successfully implemented, this reform strategy will pay dividend in terms of much higher revenue. The required increase in VAT revenue (including supplementary duty) in relation to GDP would still not be an easy task. In addition to complete reorganization and retraining of the VAT staff, and replacing most of the field level staff with new Revenue Officers, the transformation will require other major changes: (i) replacing tariff values on hundreds of products by their normal market prices; (ii) reducing the number of products subject to supplementary duty from 1,400 to something less than 200; (iii) eliminating the current practice of price approval on most items; and (iv) eliminating the excise type current account system for VAT payments and moving to proper return-based VAT administration.

ii) On the direct tax front, the challenge is more serious. NBR has a very narrow taxpayer base with only 1.3 million registered TIN holders and not all of them filing tax returns. The taxpayer base would need to expand rapidly with major registration drives. The Direct Tax Law/Codes are also outdated and would require fundamental changes based on the principle of universal taxation. The direct tax administration is also outdated, paper-based, and based on territorial/geographical administrative units. While withholding at sources is being applied recently, in the absence of a central data base, there is no way for the tax administration to follow up on additional tax payments and also administer the withholding agencies. The combined effect of all these deficiencies is the very low tax efficiency and the very low direct/GDP ratio in Bangladesh.

On the **tax policy front**, Bangladesh's direct tax system would need to focus on several important areas with a view to ensure equity, improve tax buoyancy, and enhance resource efficiency. Some of the important issues are highlighted below:

- Broadening of the taxpayers' base. This will require monitoring of the ownership of all sizable physical and financial assets of taxpayers and determining the income generation out of those assets.
- Broadening of the tax revenue sources from traditional dependence on taxing financial institutions and a few large non-financial corporations. Tax administration has the tendency to increase tax incidence on existing and complying taxpayers and not work hard on identifying the new taxpayers by gathering information from multiple sources. The so called "Black Money" is circulating in the domestic economy, it is the responsibility of the tax department to find their owners.
- Focusing on income from service providers and self-employed (who are difficult to tax).
- Treating all sources of income equally for the tax purpose without discrimination for the households. This would imply taxation of capital gains from land, real estate/housing, and stock market. Wealth accumulation in Bangladesh is primarily happening through accumulation of urban land and real estate, untaxed/low tax income of the rapidly growing RMG sector, and relatively low tax incidence on income through financial instruments. This must change. These anomalies are serious and must go.
- The simplistic manner of imposing Wealth Tax in the form of an Income Tax surcharge of 10% must be abandoned and the NBR should move to develop a proper "Wealth Tax" or "Property Tax". The current practice essentially increases the marginal tax rate by additional 10% and amounts to distorting the incentive to work or to increase tax avoidance. NBR has to build up its capacity for proper administration of property/wealth tax with proper study and identifying the right way to collect the tax, not simply by taxing the income tax in the form of a surcharge.

VI. Concluding Observations:

Bangladesh economy is growing at a respectable pace and has the potential to grow much faster. As we become a middle income country, the breadth and quality of services provided by the public sector has to expand and improve with the growing needs of the empowered population. Both from political economy and fiscal management points of view these pressures essentially translate into larger size of the government, improved quality of spending, and growing pressures for mobilizing higher budgetary revenue. While political economy pressure for higher spending will build up, if it is not matched by higher domestic revenue, imbalances will be created in fiscal management which will then lead to building up of public debt to unsustainable levels, crowding out of the private sector through increased domestic borrowing, tensions in the fiscal-monetary mix leading to macroeconomic instability. Economic literature is littered with such examples, and Bangladesh must avoid that path.

Expenditure pressures are bound to grow, and some signs of that we have already seen over the last 5 years of the current government. These pressures will simply intensify in the coming years with the growing demand for social sector services and quality improvements. Thus the government has to gear up its efforts to undertake necessary reforms and modernization of NBR to make it ready for the challenge. As discussed above, the quantitative revenue targets are achievable but challenging. The targets cannot be achieved by the current administrative machinery and modus operandi. Smart and modern tax laws, supported by reformed and modernized tax administration will be the only way the country can rise up to the challenge. The amount of investments needed for this purpose is rather modest with potentially 100 fold increase in returns in terms of higher revenue. The most important imperative is the **Political Will and Change of Mindset of the Politicians and the NBR** with regard to the required changes.

In order to develop long-term strategies relating to public expenditure and tax policies and to engender public support for adopting such strategies, the government may consider setting up of two high-level commissions, supported by high quality technical support from national and international experts. The findings and recommendations of those commissions will serve as the basis for developing the strategy for revenue mobilization and prioritization of public expenditure. The Revenue/Tax Commission will examine all aspects of Tax Policy and Tax Administration based on Expert Inputs and international and national experience. Bangladesh has a long way to go. Many piecemeal efforts in the past have either produced limited and time-bound results or have failed. We cannot afford such half-hearted efforts and we cannot fail in the drive for meeting the growing needs of the society. We have to change.