

## Are we heading towards a large revenue shortfall?

Monday, May 18, 2009

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Bangladesh has the lowest tax to gross domestic product (GDP) ratio among its comparator countries. With tax-to-GDP ratio at below 10 per cent, despite numerous ad hoc steps at different times, there is serious doubt about whether any government in Bangladesh will ever be able to provide the promised and much needed public services to the teeming millions. The newly elected government has also come to power with strong mandates and support from the people to deliver on numerous promises. The single most important factor which is likely to undermine the government's socio-economic objectives is the very low tax revenue at its disposal which is further deteriorating with the emerging large shortfall in revenue collection in fiscal year (FY) 2009.



Recent Revenue Performance: After achieving record growth in revenue in FY2007-08 (27 percent), the National Board of Revenue (NBR) set a target of Tk. 545 billion for FY2008-09. At that time it was envisaged that the targeted NBR revenue growth of 15.5% was not ambitious because of its previous performance. In the event, NBR achieved only 12.2% growth through March 2009, compared with 24.1% in the corresponding period in FY 2007-08. All major taxes recorded similar slower growth through March 2009 (Figure 2).



Based on the 5-year average trend, last year NBR revenue collection was consistently in surplus whereas this year the picture has reversed and a large shortfall is expected (Figure 4). NBR revenue shortfall through March is estimated to be TK 2013 crore. Based on the 5-year collection pattern, actual revenue through March was 4.3% below the 68% target required to achieve the budget target. The major sources of this shortfall were customs duty, domestic supplementary duty and VAT on imports (Figure 3). The revenue performance was in surplus during July-September 2008 but thereafter sharply turned into a growing shortfall. This shortfall in revenue is now estimated to increase further in the remaining 3 months of the fiscal year to about Tk. 4000 crore by end-June 2009 (Figure 4).

Why Should the Shortfall Increase in Coming Months? The latest macroeconomic indicators for Bangladesh have started to show signs of weakening in nominal terms because of the financial crisis induced sharp drop in product prices all over the world. The figures for L/C opening, which give the outlook for import payments over the next 3-4 months, are sharply down in dollar terms. After a very healthy increase 24 percent in the first quarter (July -September), LC openings have declined in dollar terms by almost 16 percent in the second quarter and further by 24 percent during January-March 2009. This negative growth is certainly a signal to a sharp fall in import value and hence in import-based revenues during the remainder of 2008/09. We have to keep in mind that the commodity price index



reached its peak of 219 points in July 2008 and then continued to fall at a very steep rate and dropped to 99.9 points by March 2009 (International Monetary Fund) - a fall of over 50%!

Tax policy changes in the 2008/09 budget and a shift in the composition of imports toward industrial inputs and capital goods also contributed to this shortfall. A comparison of the growth in import-based tax revenue with growth in import payments in domestic currency terms, points to a significant decline in import-based revenue relative to the value of imports. Tariff reduction on industrial inputs and capital machineries in the 2008-09 budget caused a

shift towards the imports of such commodities and entailed a significant loss in the import-based tariff revenue. During July-March of FY 2008-09, the share of industrial raw materials and capital machineries in the total L/C opening and settlement increased to 64.0 and 64.2 percent respectively against 59.6 and 60.0 percent respectively over the same period in FY 2007-08 (Figure 5). Further, the share of these two items in the total import payments increased significantly. During July-February 2008-09, for US \$100 of imports, US \$78.8 was spent in the imports of intermediate and capital goods while in the last year of the same period, it required US \$73.3. It indicates that following tariff reduction in the budget, the imports of these two items have increased significantly, but also causing a large amount of revenue loss.



The problem also lies in the deep cuts in tariffs in last year's budget on all shades of inputs – intermediates, raw materials, capital machinery (Table 1). Except for the top rate of 25%, all other non-zero tariffs on inputs were lowered. Whereas actual collection of import-based taxes in July-March FY08 was 7.5% of assessed import value, it is 6.3% for the same period this year. Add to this the loss in import VAT and SD, which are imposed on duty inclusive value, then you get the picture why customs revenue generally would not be buoyant this time. If input rates were not lowered as much as they were, NBR could have hypothetically collected Tk. 600 crore or 3% higher customs revenues. No wonder CD revenue is growing a paltry 1.5% as of March 09. Why blame only the global recession?

There is however some positive signs on the domestic-based taxes. Collection of domestic-based taxes like income tax and domestic VAT exceeded the target, which is a positive development. This development essentially points to a stronger domestic activity despite the gloomy global economic environment. This development is not surprising since the decline in import value (particularly when it is induced by falling commodity prices) is not necessarily a sign of general weakness in domestic economic activity. Bangladesh is a large net importer of goods of both primary and finished types and the merchandise trade balance is large and widening every year. Thus Bangladesh economy must have made significant terms-of-trade

gains through the sharp decline in the global commodity prices and this should help sustain domestic demand and economic activity



contributing to this revenue gain from domestic sources.

Despite this positive sign on the domestic front, the overall revenue picture is going to be quite disappointing. The shortfall in NBR revenue is estimated at Tk. 40 billion, entailing a significant reduction in the tax-to-GDP ratio to 8.6 percent of GDP from 9.3 percent in FY 2007/08, reversing much of the gain recorded in 2007/08. The overall revenue to GDP ratio in Bangladesh is one of the lowest in the world and seriously limits government's capacity to deliver public services. This further reduction will make the problem even worse.