



## Challenges of financing Seventh Five-Year Plan

Thursday, Dec 3, 2015

By *Dr. Sadiq Ahmed*

Building on the success of the 6th Five-Year Plan, the Government has set ambitious targets in the 7th Five-Year Plan for further accelerating GDP growth and lowering poverty. Furthermore, the government for the first time has focused attention on reducing income inequality through a concerted fiscal policy effort. These targets in the 7th Plan for GDP growth, poverty reduction and income inequality pose a strong challenge for mobilising adequate financing from private and public sources. This article provides a review of this financing challenge drawing on the experienced gained during the 6th Plan period.

GDP growth performance record: The rate of expansion of GDP over the different plan periods is indicated in Table 1. The Table tells a remarkable story of a rapidly growing economy, albeit from a very low initial base in the 1970s. The average GDP growth was fairly stable at around 4% per year during the first 4 five year plans over the periods 1973-1995. There was a substantial break from this slow-growing historical past as GDP growth took off during the fifth plan (1997-2002), reaching 5% and then accelerated during the sixth plan to 6.3% per year. Aided by a very successful population management policy, per capita GDP growth moved up in every plan period, initially very slowly (1-2% range) but then accelerated to around 5% average rate during the Sixth Plan (Figure 1). The GDP growth acceleration

achieved during the Sixth Plan has been instrumental in taking Bangladesh to the threshold of low middle-income status as defined by the World Bank.

As in previous plans, the actual GDP growth rate fell below the target rate. The shortfall is particularly noticeable during the later-half of the Sixth Plan (Figure 2). In addition to political difficulties, the main contributing factor was the shortfall in the investment rate, both public and private. Nevertheless, the ratio of actual GDP growth to the average planned GDP growth achieved in the Sixth Plan was the highest among all plans. Most importantly, the GDP growth performance in the Sixth Plan puts Bangladesh amongst the best performing nations globally (Figure 3).

Growing at an average pace of 7.8% per annum over the five years of 2011-2015, China was the global GDP growth leader. Remarkably, Bangladesh grew at 6.3%, ahead of India, Thailand, Indonesia and the average for all developing countries. The performance is even more impressive when compared with the average growth in sub-saharan Africa, Latin America, OECD countries and the global average.

**Growth drivers: The rate of investment:** Research shows that while the growth of labor force and, recently, the total factor productivity have contributed to GDP growth, the most important growth driver in Bangladesh has been capital accumulation. The national investment rate (investment as a share of GDP) has grown steadily over the years, starting from an initially low level of 10-15% of GDP during the two decades of 1970 and 1980 and then accelerating since the early 1990s to reach 26.3% of GDP by FY2010 (Figure 4). Much of this investment effort came from the private sector; the public sector investment rate has been generally low and on a declining trend. The total investment effort showed modest progress during the 6th plan including some recovery in public investment.

Along with increasing investment rate, there is also evidence of growing average capital intensity of production reflected in rising incremental capital output ratio (ICOR). The increasing capital intensity of production (Figure 5) is consistent with global experience of transition from low income to middle income status. The rationale for this increase is that at low levels of income, where agriculture and informal services dominate economic activity, the capital intensity is relatively low. As the country transforms to a manufacturing and services based economy, the capital intensity of production grows. Indeed, the need for

Bangladesh to increase average labor productivity requires investments in new technology, infrastructure and skills development that will contribute to a growing capital intensity of production. The increasing ICOR means that per unit of additional output Bangladesh will require higher incremental capital. This is an important reality that will underpin the transition of Bangladesh from lower middle income to upper middle income group.

Recognizing the importance of investment to support higher GDP growth, the Sixth Plan targeted an increase in the investment rate growing by around 8 percentage points of GDP, from 26% of GDP in FY10 to 34% by FY15, as a critical driver of growth. While private investment was projected to lead the way, a substantial increase in public investment was also planned (Table 2).

The actual investment performance fell much shorter of the 6th Plan target. Both public sector and private sector failed to deliver. In the public sector, the two major constraints were inadequate revenue mobilization and the inability to push the public-private-partnership (PPP) initiative. Total tax revenues grew by a mere 1.5% of GDP, from 7.8% of GDP in FY10 to 9.3% of GDP in FY15, as against the 6th Plan target to increase the tax/GDP ratio by 4 percentage points. The PPP initiative brought in an additional 0.5% of GDP equivalent of resources per year as compared with the target of 1.5%. In the private sector, the main reasons for shortfall include political disturbances and uncertainties, weak investment climate reflected in poor international ranking of Bangladesh by the International Finance Corporation's (IFC) "Cost of Doing Business" rankings, and difficulties of getting serviced land. The Sixth Plan's inability to cross over to the 7% rate of growth of GDP to a large extent is a reflection of this investment constraint.

GDP Growth target of the 7th Plan: Against the backdrop of the 6th Plan experience, the 7th Plan reasserts the Government's intention to reach the 8% growth target by FY20 (Figure 6).

To secure the GDP growth rates projected for the Seventh Plan, it is estimated that the investment rate will need to expand from 27.9% in FY2015 to around 34.4% by FY 2020. Much of this investment will need to go to enhance infrastructure, improve labor skills and boost manufacturing production. The projected investment requirements for the Seventh Plan are indicated in Figure 7. While these indicative investment rates have been derived by using the latest 5-year ICOR (4.3) shown in Figure 5, they were cross-checked for consistency with

a sectoral General Equilibrium Model (GEM) used for simulating growth, investment and employment outlook of the Seventh Plan.

The 7th Plan poverty reduction and income inequality targets: Bangladesh has a solid track record in reducing poverty and this performance gained momentum since 2000, buoyed by growth acceleration (Figure 8). The observed elasticity of poverty reduction with respect to GDP is estimated at around 0.8 (2000-2010); this elasticity is an amazing 1.1 for extreme poverty (lower poverty line). These suggest that inclusive GDP growth is the best means for reducing poverty further. Along with higher rate of GDP growth, the 7th Plan strategy seeks to reduce poverty through the implementation of a revamped National Social Security Strategy (NSSS) and by taking fiscal policy measures to lower income inequality. The projected reduction in poverty from FY2015 to FY2020 is shown in Figure 8. Moderate poverty is projected to fall to 18.7% and extreme poverty to 8.5%. The focus on income inequality is a new dimension of public policy making in Bangladesh and is motivated by the recognition that long-term income inequality has been rising in Bangladesh (Figure 9), which is not a good outcome for either poverty reduction or long term social stability

Adding Up — The 7th Plan Financing Challenge: The 7th Plan's targets for higher growth, lower poverty and lower income inequality all have substantial implications for resource mobilization. While many other factors will influence the ability to implement these ambitious targets, the most critical determinant will be the ability to mobilize the required financing. There are two dimensions of the financing challenge: private resource mobilization and public resource mobilization. The private resource mobilization concerns the ability to finance the large increase in private investment rate envisaged in the 7th Plan. The public resource mobilization challenge is to provide additional resources for financing public investment to support higher growth and to invest in human development and social protection (involving both current and capital spending) for poverty reduction and lowering of income inequality.

The financing challenge for growth: As noted in Figure 8, the total national investment rate will need to grow from 27.7% of GDP in FY15 to 34.4% of GDP in FY20, which is a 6.3 percentage points of GDP over a 5-year period. In comparison, the total investment rate grew by a mere 1.4 percentage points of GDP during the 6th Plan. The financing challenge of this massive increase in investment is no doubt daunting. Obviously, the policy regime of the

6th Plan will not support this massive increase. Substantial additional reforms will be needed.

The way forward consists of looking at the expected contributions of the different sources of financing, understanding the present policy constraints and addressing those concerns systematically and with determination. There are three entities that will need to contribute to the financing of the investment effort: domestic private sector; foreign sector (direct foreign investment and foreign borrowings); and the public sector. The investment financing plan projected in the 7th Plan is shown in Table 3.

**Private sources of financing:** Much of the financing resources (on average 88%) will come from the national savings effort. Bangladesh has a good track of increasing national savings, growing from less than 7% of GDP in the 1970s to a high of 29% of GDP in FY12. This effort gained momentum from private transfers based on remittance from abroad. These remittances now amount to almost 8% of GDP. The national savings rate fluctuated around 27-29% of GDP during the 6th Plan, with a sharp decline in FY15, for a number of reasons including capital flight owing to political uncertainties, weak domestic investment climate and weak fiscal effort. These trends will need to be offset with proper policies during the 7th Plan.

The outlook for further increases in foreign remittances is positive. Bangladesh needs to take steps to train workers, support the worker transfer process and continue to strengthen remittance inflows through the banking sector. Efforts to strengthen law and order and greater political stability will help reverse capital outflows. Another important determinant of national savings rate is private corporate savings. Improvement in the investment climate through reductions in the cost of doing business will stimulate private corporate reinvestments.

Bangladesh has pursued a cautious foreign borrowing policy that has served the country well. But it is now time to change gear somewhat and take advantage of the flexible and low-cost foreign financing to help foster development. Foreign financing, especially foreign direct investment (FDI), is also a major source of technology transfer. In view of this, the 7th Plan resource mobilization strategy must allow greater use of foreign resources. Accordingly, the suggested financing strategy projects a modest increase in foreign savings to finance the 7th Plan. Much of the increase in foreign savings will come from FDI. Improvement in the

investment climate will benefit both domestic investment and FDI. Particular areas where the cost of doing business has to be reduced concerns the ease of procuring serviced land, the ease of getting access to electricity and other utilities, reducing trade logistic costs, and improving the legal framework for bankruptcy resolution and contract enforcement. Regarding official foreign borrowing, the main task is to better use the growing foreign aid pipeline to finance development needs.

Fiscal management: Perhaps the biggest financing challenge is in the area of public finances. The fiscal policy is on track regarding macroeconomic prudence. The budget deficit has been constantly below 5% of GDP and total debt to GDP ratio has been falling. This has supported private investment by avoiding a crowding out impact of fiscal policy and helping monetary policy in fighting inflation. However, fiscal policy has been deficient in expanding public spending for growth, poverty reduction and lowering income inequality.

First, there is a major shortfall in tax performance. Compared with the Sixth Plan target of increasing tax to GDP ratio by 4.6 percentage points to 12.4% of GDP by FY2015, the actual tax to GDP ratio increased to 9.3% of GDP, which is an increase of 1.5 percentage points only. This is partly because of the upward adjustment of GDP that has compressed all ratios, but mainly due to fact that the implementation of the Tax Modernization Plan has been much slower than expected. Second, fiscal discipline has often required either cutbacks or inability to meet the Sixth Plan commitments in certain high priority areas of spending (e.g. in education, health, social protection and environment). Third, procurement problems have slowed down the implementation of major infrastructure projects. Fourth, the important policy initiative of public-private-partnership in infrastructure did not gain momentum.

Continued prudence in fiscal policy management is necessary; yet this alone is not enough to meet the growth, poverty reduction and income inequality targets of the 7th Plan. A major challenge for fiscal policy would be to strengthen resource mobilization. To support higher growth, the topmost priority is to increase public spending on infrastructure (electricity, primary energy, irrigation and water resource management and transport). Concerning income inequality, the 7th Plan strategy is based on a realization that a dynamic redistribution of wealth, assets and income through policies, regulations and institutions that seek to increase human capital and earnings capabilities of the poor citizens hold much better promise and prospects than any effort to redistribute wealth through controls and

limits over asset ownership.. Access to better education and healthcare is a fundamental right of the Bangladeshi citizen and requires utmost attention of the government. A strong social protection system is another instrument for improving income distribution. These policies have worked in Western Europe to contain and lower income inequality. There is no reason why they should not work in Bangladesh.

The fiscal policy implication for supporting growth, poverty reduction and lowering income inequality is illustrated in Table 4.

Despite strong emphasis during the 6th Plan, total public spending on electricity, energy and transport could only reach 2.1% of GDP. This is highly inadequate to finance the infrastructure needs of a middle income Bangladesh that is aspiring to attain 8% GDP growth. While infrastructure modernization will likely require annual investments of 5-6% of GDP, the public sector alone cannot support this large financing requirement. So, a reliance on PPP initiative is essential. From the government budget a minimal target would be to increase infrastructure spending by at least an additional 1.4% of GDP by the end of the 7th Plan, reaching 3.5% of GDP. The remaining gap will have to be addressed through a major overhaul of the PPP facility.

Another area where public spending has to increase to support higher growth is agriculture and rural development – farm technology, rural roads, irrigation and flood control. Past government spending in this area has helped increase farm productivity and food production. The near food self-sufficiency of Bangladesh despite rapid population growth is a testimony to the success of this policy. Yet, much of the rural labor force remains engaged in low-productivity and low-earnings agriculture. There is a need to diversify agriculture into higher value-added activities and to help transfer surplus labor from agriculture to non-farm activities in rural and urban areas. This transformation will support both growth and income distribution by helping increase average labor productivity in the economy. In light of budget constraint, an additional spending of 0.7 percent of GDP on rural infrastructure annually will be helpful, which will increase total public spending on agriculture and rural development to 3.0% of GDP by FY20.

In addition to public spending on rural infrastructure, the availability of rural credit is an important determinant of this transformation. The micro-credit revolution has helped the poor

to build up assets and also protect their consumption, thereby contributing to lower poverty. Nevertheless, the scaling up of formal credit to the rural economy remains a huge challenge.

Regarding poverty reduction and lowering of income inequality, the top most policy priority is to raise the share of public spending on education and health to at least 3.0% and 1.5% of GDP respectively by the end of the 7th Plan. These spending levels will still be very modest and much below the levels necessary to address the human development challenge of middle income Bangladesh. To improve the effectiveness of public spending, policies will be needed to secure major improvements in the delivery of public education and health services through policy, governance and institutional reforms. Efforts are also necessary to improve the equity aspects of these spending.

A third area where public spending has to grow is social protection. Presently the government spends 1.7 % of GDP on social protection. This is too small. This should grow to at least 2.7% of GDP over the next 5 years. Concomitantly, a top priority is to implement the new National Social Security Strategy (NSSS).

Higher public spending on infrastructure, agriculture, rural development, education, health, and social protection by an additional 5.3% of GDP is a seemingly tall order in the present environment of public resource constraint. A closer look suggests that a strategy to mobilize this additional funding is certainly within the reach of public policy.

A major reason for the resource constraint is low tax collection, especially from personal income taxes. Presently, the effective personal income tax rate of 3% is very low. Increasing the effective income tax rate to just 10% in the next 5 years for the top 10 percentile of the population who own 35 percent of the national income will alone yield revenues of 3.5% of GDP, instead of 1.4% now for the entire personal income tax collection. This illustrates the huge potential for increasing revenues through a progressive personal income tax regime. To achieve this, it will require closing of loopholes that lets most capital gains escape the tax net, treating all sources of personal income equally for taxation purpose, and improving tax administration and compliance. The modernization of VAT and improving its productivity can yield an additional 1.8% of GDP. Furthermore, the introduction of a modern property tax system and assigning this to the local governments can be a substantial boost for their fiscal autonomy while providing revenues.

This additional tax effort focused on personal income, VAT and local government revenues (5.3% of GDP) can finance the additional public resources required for supporting growth acceleration, poverty reduction and lowering income inequality (Table 5). This fiscal policy package can be a powerful instrument for improving income distribution as the incidence of this tax and expenditure package is likely to be progressive.

One important point to note is that apart from resource mobilization, there is scope for improving expenditure management. A major example is management of energy subsidies. Historically the government spends a substantial amount of resources on energy subsidies (fuel oil and electricity). Recent decline in global oil prices has lowered this cost, but without structural change in setting energy prices and improving the distribution of energy products based on a competitive and efficient market, the energy subsidy issue might overwhelm budget management as in the past. Large public spending on energy subsidies is not justified on equity grounds. The energy subsidy can be limited to a small amount by targeting this to the poor only. The saved resources can be diverted to the social service spending in the above-mentioned priority areas.

There are similar other examples where public expenditure management can be improved. These include: reform of state owned enterprises; reform of state-owned banks; improved public procurement; improved financial management; and improved project selection and implementation.