



Economic and social impact of the FY2019 budget

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There is a lively ongoing debate about the likely economic and social impact of the FY2019 budget. Much attention has been given to how a few extensions in the coverage of the VAT will hurt the middle-income group and how a small reduction in the corporate tax rate for the banking sector will benefit the fat cats sitting at the top of the income stream. Yet, surprisingly, there is no debate about the annual loss of \$14 billion of income for consumers owing to continued trade protection well preserved in the proposed budget. Importantly, we need to look into the big picture to assess the likely economic and social impact of the budget.

A typical national budget affects economic and social outcomes through two possible channels. First, through the underlying policy framework and second, through the taxation and spending programmes of the budget. In some ways, the policy framework could be much more relevant than taxation and spending.

Effect on GDP and investment: On the economic front, the most important question is the effect on GDP growth and investment. The FY2019 budget policy framework, taxation and spending all fall short of the targets set in the Seventh Five Year Plan (7FYP). Combined with the shortfalls of the past three budgets, it is most unlikely that the GDP targets of the 7FYP would be realised. The results so far show that the private investment rate, FDI inflows, and export growth all fall short of the 7FYP targets.

The public investment rate is a mystery. Owing to revenue and implementation constraints, the public investment funded through the national budget has been around 5 percent of GDP during FY2016-FY2018. On the other hand, the Bangladesh Bureau of Statistics (BBS) figures show this as 8.2 percent of GDP for FY2018. Who is investing and financing this huge gap between the budget estimates of public investment and the BBS estimate?

The state-owned enterprises (SOEs) and local governments by and large depend upon national budget transfers to survive. Total outstanding debt of the SOEs was \$24.5 billion in FY2017. In this reality, it is nearly absurd to imagine that SOEs and local governments are investing 3 percent of GDP from own resources!

The shortfalls on the policy front are similarly large. No trade reform has happened. Banking sector difficulties have cumulated. Private sector investment climate is constrained by high transaction costs. According to the World Bank's Cost of Doing Business Indicators, Bangladesh is at the bottom end of the countries ranked and this ranking has not improved in the past three years. Unless the BBS is able to provide a credible explanation of what is driving GDP growth that makes it possible to stay on track as per the 7FYP even as investment and policies are off-track, the most logical conclusion is that the actual GDP growth will miss the 7FYP target.

Macroeconomic stability: The track record on macroeconomic stability is much better so far and the FY2019 budget seeks to preserve this by keeping a lid on fiscal deficit. The budget

also seeks to rely more on foreign financing based on the better use of the aid pipeline. These are positive features. By proposing to keep the bank borrowings within prudential limit and consistent with the monetary policy targets, the budget will likely help keep inflation under control at around 5.5 percent rate if this policy is implemented. This will also support private investment by avoiding a crowding-out effect on private credit.

One concern though is the growing deficit in the current account of the balance of payments. If this deficit is helping finance investment, the gap is not an issue. However, there are concerns that a significant part is capital flight through over-invoicing of imports. Another concern is that export growth is slow. It can't forever remain much behind import growth. So, boosting export growth through diversification is an imperative. This brings us back to the policy framework of the FY2019 budget, which does not address the export diversification issue.

Technology transfer: Sustained GDP growth also depends upon technology transfer. Two most important policies for this are foreign direct investment (FDI) and investment in research and development (R&D). Bangladesh is lagging in both areas.

FDI inflows in Bangladesh in 2017 were a mere \$2 billion compared with \$229 billion for China (including Hong Kong), \$58 billion for Singapore, \$45 billion for India, and \$18 billion for Vietnam. In addition to the deficit in infrastructure, the cost of doing business remains incredibly high in Bangladesh. The proposed budget along with earlier budgets puts emphasis on infrastructure spending but the financing gap is large and implementation is very slow.

The budget does not offer anything concrete in terms of reforms to ease the pain of the high cost of doing business. Even the One-Stop-Shop for investors promised in 2016 remains to be implemented.

When it comes to R&D, available estimates show that Bangladesh invests a mere 0.15 percent of GDP compared with 1.5-2.0 percent of GDP in China. While much of the R&D spending will come from the private sector, the budget needs to spearhead this with research grants and tax breaks. There is no systematic R&D policy in FY2019 budget or any previous budget. This is a huge gap in policy-making that must be corrected quickly to take Bangladesh to the upper middle-income status.

Job creation: On the social front, the most important challenge is job creation. The 2016 Labour Force Survey shows disappointing results for new job creation in the organised manufacturing and organised services. While the labour markets seems to have tightened in rural areas, reflected in rising farm real wages and growing mechanisation, the out-migration to urban areas has seen a huge growth in informal sector activities, especially services.

In the organised sector, there is a mismatch between demand and supply owing to low education and skills of available workers. In this digital age, production technology is changing rapidly globally and in Bangladesh. The types of skills needed for employment in organised manufacturing and services are in short supply in Bangladesh.

The agenda for converting the largely uneducated and untrained existing labour force into educated and high-skill labour force for the 21st century is huge. The government has given priority to this in all budgets, including the proposed one. But the scale of effort needed and resources required far outstrips the government's present fiscal and administrative space.

For example, the resources needed for human capital formation are estimated at about 2 percent of GDP for health and 4 percent of GDP for education and skills. Compared to this, Bangladesh invests about 0.7 percent of GDP in health and 1.9 percent of GDP in education and training. This level of allocation prevails in the FY2019 budget. The limited fiscal space owing to very low tax-to-GDP ratio (9.5 percent) is a huge constraint. Implementation capacity constraints are additional challenges.

Poverty reduction: The impact of the FY2019 budget on poverty reduction will remain positive largely because of the growing economy. Although it is unclear whether the real economy is growing at more than 7 percent, it is buoyant. Even a 6 percent plus growth rate is a solid performance and will have a major positive impact on poverty reduction.

Income inequality: Another major social issue is the incidence of growing income inequality. Global experience shows that the two most important instruments for reducing income inequality in a market economy are income transfers to the poor and vulnerable through a well-defined and well-funded social security system, and the institution of a progressive income taxation. On both counts Bangladesh is seriously lagging.

As compared with spending levels of 12-19 percent of GDP on social protection in Western Europe, Canada and Japan who all have relatively low level of income inequality, Bangladesh spends 1.2 percent of GDP (excluding civil service pensions). There are also serious efficiency issues. The government sought to address these inefficiencies by adopting a comprehensive National Social Security Strategy (NSSS) in 2015. But so far, this has not been implemented. There is no indication in the budget that the NSSS will be implemented, which is a huge disappointment.

Progressive income taxation is mostly missing in Bangladesh. Total personal income taxes are a mere 1.4 percent of GDP whereas 35 percent of national income is owned by the top 10 percent of the population.

Sustainable development: Finally, environmental degradation and climate change continues to take its toll on Bangladesh. The adverse consequences of natural disasters on the poor and vulnerable are particularly telling. The budget does not include any new reform to address the many outstanding issues. The Delta Plan formulated in 2017 is still not approved by the government. Pricing policies continue to favour fossil fuel consumption and discourage adoption of clean technology. Very little use of environmental fiscal policies is made to discourage carbon emission, reduce water pollution and improve drainage and solid waste management. The adoption of a carbon tax as done by India and China will be a win-win that will not only reduce air pollution but also generate substantial fiscal resources.