

## Equity implications of national budget for FY 2015-16

Monday, Jun 22, 2015

By *Dr. Sadiq Ahmed*

In a market economy fiscal policy is the most potent source of improving the equity of development. Well developed and targeted public spending on rural development, human development and social protection can have substantial positive effects on improving the well-being of the poor and vulnerable population. Rural spending on agriculture, water resources, rural electrification and rural roads can have determining effects on farm and other rural income. Public spending on education and health with focus on the poor improves their opportunities to participate in the growth process and over the longer term can help lower the disparity between the rich and the poor. A well designed and adequately funded social protection programme can play a large role in protecting the poor and vulnerable population from shocks while also guaranteeing them a predictable source of income.

The equity effects of public spending can be strengthened by ensuring that these programmes are largely funded through a system of progressive personal income taxation. The more that fiscal policy relies on a progressive system of personal income taxes and less on indirect taxes or bank borrowings, the higher the effectiveness of fiscal policy in improving income distribution.

The best examples of countries that have effectively used fiscal policy for ensuring equity of development belong to Western Europe. Countries like Norway, Sweden, Denmark, Germany and France spend between 12-19% of gross domestic product (GDP) on social protection. They also spend 5.0-7.0% of GDP on education. These large public spending are mostly financed through a progressive personal income tax system. These countries exhibit low income inequality as measured by the gini coefficient of income. Theoretically, the value of gini ranges from 0 to 1, with a lower value indicating more equality of income distribution. The gini coefficient for these countries is in the 0.25 to 0.30 range, signifying low income

inequality.

Canada and Japan also use fiscal policy effectively to strengthen the equity of development. In comparison, Bangladesh spends a mere 2.4% of GDP on health and education from the budget and social protection spending is only 1.7% of GDP. Additionally, both these spending were on a falling trend as a share of GDP during the Sixth Five Year Plan period. On the financing front, while total income taxes have grown, they are still only 3.7% of GDP. Personal income taxes are a mere 1.4% of GDP, whereas 35% of income accrues to the top 10 per cent of the population. Not surprisingly, income inequality has been on a rising trend over the longer term, with the gini coefficient of income growing from 0.36 in 1983-84 to 0.46 in 2010. The income share of the bottom 10% has fallen from 2.9% in 1983-84 to 2.0% in 2010, whereas the income share of the top 10% has grown from 28.3% to 35.8% over the same period. The challenge for fiscal policy is enormous.

The likely equity effects of the proposed national budget for the fiscal year (FY), 2015-16, can be assessed by looking at its expenditure priorities and comparing them with the projected expenditure requirements that are consistent with higher GDP growth and improved equity targets of the 7th Five Year Plan. This is shown in Table 1. To secure 7.0-8.0% growth and to reduce income inequality, total public spending requires to increase by 6.0 percentage points of GDP during the 7th Five Year Plan period. Much of this increase (4.6%) needs to be allocated to rural development, human development and social protection. This is a huge spending challenge, but not impossible.



As compared with these targeted 7th Plan expenditure requirements, total expenditure in FY2015-16 is budgeted to rise to 17.2% of GDP, which is an increase of 2.1% of GDP over FY2014-15. While this increase in total spending is consistent with the 7th Plan spending target, much of the additional spending (1.4% of GDP) will go to finance the Civil Service Wage Award, leaving a mere 0.7% of GDP of additional resources for other high-priority uses. Of this, some 0.5% of GDP of additional spending goes to infrastructure, leaving almost nothing to boost equity-related spending. So, from the equity perspective, the FY2015-16 budget's spending strategy will remain almost unchanged from the FY2014-15 budget outcome and as such will not likely make any positive contribution to improving equity over

the medium term.

The story on the financing side is no more encouraging. The budget proposes to finance the additional 2.1% of GDP of additional spending through tax increases (1.3% of GDP) and through higher deficits (0.8% of GDP). The budgeted increase in taxes is consistent with the 7th Plan fiscal framework, which is a positive sign. However, much of the increased tax revenues are projected to come from value added tax (VAT), customs revenues and supplementary duties. Income taxes are projected to grow only marginally from 3.7% of GDP in FY2014-15 to 3.8% of GDP in FY2015-16. The yield of personal income taxes will remain basically unchanged as a share of GDP. So, on the tax side also, the FY2015-16 budget does not seem to make any positive contribution to addressing the equity agenda of the 7th Plan.

This continued inability of fiscal policy to improve the equity outcome remains a worrisome development of public policy in Bangladesh. While the focus on growth is appropriate and must continue, the government needs to think through more how it can use fiscal policy as an active instrument for improving equity during the next four budgets of the 7th Plan along the lines articulated in Table 1. The additional spending of 4.6% of GDP required to improve equity during the 7th Plan is financeable through a combination of spending cutbacks and additional taxes from personal income.

On the spending side, policies can be taken to cut back spending on energy subsidies, deficits of public enterprises and the transfers to the state-owned banks by reforming all these state-owned enterprises. Energy prices should be de-linked from the budget by making these operations market based, while the state owned enterprises including public banks must be required to earn a profit. The saved resources (1.0% of GDP) could be used for financing higher spending on human development.

The remaining 3.6% of GDP can be obtained through a radical reform of the income tax system. Even with an effective income tax rate of 15%, personal income tax yield from the top 10% of the income group who own 35% of the total income, would amount to 5.3% of GDP as compared with 1.4% of GDP collected presently. This reform alone would dramatically change the fiscal performance in Bangladesh. Implementing this reform requires commitment from the highest level of political leadership.