Implementing the Seventh Plan's strategy for lowering income inequality

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The Seventh Five Year Plan took a bold step by accepting that the growing long-term income inequality in Bangladesh is a matter of concern and it must be addressed during its period of implementation from fiscal year (FY) 2015-16 to FY 2019-20. It also provided a thoughtful strategy for tackling income inequality, drawing on the experiences of countries that have achieved both high per capita income and relatively low income inequality. It is heartening to note that in a recent public forum Finance Minister AMA Muhith acknowledged that income inequality indeed is an important development challenge.

The new national budget for FY 2016-17 – the second year of the 7th Plan — is in the making now. So, this is an opportune time for the government and the Finance Minister to begin to develop a medium-term income inequality reduction policy framework. As the 7th Plan rightly notes, fiscal policy is at the heart of a viable strategy for lowering income inequality in the context of a modern market economy as in Bangladesh.

The Finance Minister's task is made easy by the fact that the 7th Plan already has articulated a thoughtful fiscal programme for reducing income inequality over the five-year period of the Plan, ending in fiscal 2020. The 7th Plan, which is the government's current medium-term development strategy, has been endorsed by the cabinet, the Prime Minister and the National Parliament. As such, the income inequality reduction strategy is also endorsed. The challenge now is to implement the strategy.

Table 1: Seventh Plan Fiscal Reforms for Lowering Income Inequality (% of GDP)

The fiscal policy contents of the 7th Plan income inequality reduction strategy are shown in Table 1. This is a remarkable table and powerfully summarises in one place the main elements of the medium-term fiscal policy framework for reducing income inequality.

MEDIUM-TERM EXPENDITURE POLICIES FOR REDUCING INCOME INEQUALITY: The 7th Plan recognises that the most potent way of lowering income inequality over the longer term is through a re-distributive fiscal policy that finances critical programmes for the poor and the under-privileged members of the society based on a progressive system of income taxation. The core public programmes where spending has to increase are: education (additional 0.8% of GDP by the end 2020); health (0.4% of GDP); social protection (0.3% of GDP); and rural infrastructure (1.0% of gross domestic product or GDP. These core programmes tend to support income, employment, human development and social security of the poor and the vulnerable.

MEDIUM-TERM TAXATION POLICIES FOR REDUCING INCOME INEQUALITY: Total additional spending proposed for reducing income inequality during the 7th Plan amounts to 2.5% of GDP. This is a significant increase, especially in light of additional spending needed for other priority programmes, particularly in infrastructure. However, the proposed financing plan in Table 1 shows that relative to the potential for raising tax resources, this additional amount is modest and realistic. The 7th Plan rightly focuses on income taxes as the most important source of additional revenue collection that is also consistent with the objective of reducing income inequality.

Presently Bangladesh collects around 1.0% of GDP from personal income. This is a very weak performance by any reasonable standard and especially in the context of growing incomes in Bangladesh. According to 2010 Household Income and Expenditure Survey (HIES) data, the top 10% of the population owns 35% of the national income, So, even with a 10% flat tax rate, personal income tax yield should be 3.5% of GDP. More reasonably, the effective tax rate after various exemptions and allowable deductions must not be lower than 15%. If so, personal income tax collections should reach at least 5.2% of GDP, which is an increase of 4.2% of GDP. This alone should more than compensate for the additional 2.5% of GDP spending advocated for raising the incomes of the poor and vulnerable by the 7th Plan.

However, given the political economy dimensions and the influence of the rich in policy making, the 7th Plan suggests a more modest targeted increase in personal income tax revenues by about 2.5% of GDP by 2020. The 7th Plan also advocates the need for broadening the tax effort to increase revenue collection from value-added taxes by 1.8% of GDP over the plan period and by strengthening the revenue base of the local governments through the introduction of a well-designed property taxation (yielding an additional 0.5% of GDP by the end of the 7th Plan). Both are good tax instruments from the equity perspective and fully consistent with the objective of lowering income inequality.

IMPLICATIONS FOR FY2016/17 NATIONAL BUDGET: The medium-term fiscal policy framework defined in the 7th Plan for lowering income inequality is a thoughtful programme and deserves utmost attention by the Finance Minister and the National Board of Revenue (NBR). The medium-term fiscal targets for both expenditure increase and tax revenues are politically feasible and within the realm of fiscal prudence and realism. This fiscal programme can be achieved through incremental reforms of taxation and expenditures starting in the forthcoming FY2016/17 budget.

On the expenditure side, the additional yearly increases for the priority programmes are very modest (Table 1), highly realistic and essential. In total they amount to an additional increase of only 0.7% of GDP for FY2016/17. Public spending on human development in Bangladesh is amongst the lowest for a middle income economy and must be swiftly corrected. Similarly, spending on social protection has been rapidly declining as a share of GDP and must be reversed to ensure a more caring and inclusive society.

While these additional expenditures are necessary for improving the incomes of the poor, higher allocations alone are not enough. There is evidence that the quality and equity aspects of even these areas of public spending have problems and they must be addressed to ensure that a higher percentage of the related programme benefits reach the poor and the vulnerable.

In particular, the National Social Security Strategy (NSSS), adopted in 2015, must be swiftly implemented to get the desired results from spending on social protection. Reforms of public spending in health and education are also needed to eliminate corruption and shift more programme benefits to the poor. Additionally, the delivery of health and education services

must be reformed to provide greater role to local government agencies and community organisations in spending decisions and in implementation.

On the taxation front, the government is very much aware of the deplorably low tax revenue performance and has been making efforts to reverse that by modernising the value added tax (VAT). This is welcome but not enough. Policy must now shift to modernising personal income taxation and introducing a modern system of property taxation. A beginning to these reforms must be signalled in the forthcoming national budget for FY2016/17.