

## Proposed national budget for FY 2015-16 and GDP growth

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The annual national budget is the most influential public statement of the government's current economic thinking and policies. The proposed national budget for the fiscal year (FY), 2015-16, gains added significance because it is the first year of the implementation of the forthcoming Seventh Five Year Plan (7th FYP). As such, the budget conveys important signals of the government's medium term policy directions.

Given the importance of this strategic document, it is appropriate to carefully review the main features of the budget and provide feedback on how citizens perceive the government's proposed policy directions, highlight related concerns and provide constructive ideas of what might be done to address those concerns.

I propose to share my analysis and views on three aspects of the budget through a series of write-ups, each covering one aspect. These are: budget's impact on gross domestic product (GDP); implications for equity; and implications for public sector reforms. Each of these issues is of primary concern to people's welfare and as such ought to be the focus of review of this strategic document. Also, I take a positive approach that does not simply dismiss a target as "too ambitious and cannot be achieved" to assessing the adequacy of the proposed reforms, identifying the gaps and suggesting what additional reforms are needed to achieve the stated targets.

Because of leads and lags in the transmission of effects of current taxation or spending on GDP growth, the impact of any fiscal policy action is best seen on a multi-year basis in the context of a medium term framework. The forthcoming 7FYP provides this framework. The 7th Plan seeks to move Bangladesh up from the 6.0% GDP growth path realized during the 6th Plan to a 7.0-8.0% growth path. Accordingly, the FY16 budget is underpinned by a 7.0%

GDP growth target. The idea is to incrementally move up to achieve 8.0% by FY20 (end year of the 7th Plan).

How does the FY16 budget seek to facilitate this growth path? The best approach to examining this question is to look at the experience of the 6th Plan that had envisaged a similar growth path but ended up staying on the 6.0% path. There are several drivers of growth and the budget's growth impact can be assessed in terms of effects on these growth drivers. It is important to note that the budget is only one policy instrument. There are several other factors that influence growth including political stability, cost of doing business, human development, technology, governance and institutions. The budget mainly affects three growth drivers: macroeconomic stability, investment and exports.

**MACRO-ECONOMIC STABILITY:** A stable macro-economy has been the hallmark of long-term macro policy management in Bangladesh that has been a major enabling factor in spurring private investment. Prudent fiscal management has played a key role in this regard. Fiscal prudence was maintained during the Sixth Plan. The FY16 budget similarly continues this good practice. The budget deficit is contained at 5.0% of GDP and much of the planned increase in the budget spending is expected from tax resource increases.

However, the financing of this deficit through bank borrowing needs to be kept consistent with the monetary policy framework that seeks to further lower the inflation rate. Otherwise, there is risk of a crowding-out effect on private investment. The favourable global external environment and the expected balance of payments outcome are both positive factors for higher growth.

**EXPANSION OF THE INVESTMENT RATE:** The most important driver of growth is investment. The experience of East Asian economies shows that the capital intensity of production rises as the economy moves from a low-income to a middle income stage. Bangladesh is no exception. The 6th Plan had projected that the investment rate will increase by 8.0 percentage points of GDP to move from the 6.0% growth path to the 7.0-8.0% growth path. In the event, actual investment rate increased by a mere 2.0 percentage points of GDP. This failure of the investment target is the main reason why GDP growth rate remained at the 6.0% level. Both public and private sectors experienced investment shortfalls.

In the public sector, a combination of inability to secure the projected increase in the tax-to-GDP ratio, low foreign aid utilization, diversion of public resources to energy subsidy, transfer payments to state-owned enterprises (SoEs) including public banks, and inability to prop up the public-private-partnership (PPP) initiative all constrained the public investment rate. In the private sector, political instability, infrastructure constraints, especially a severe gas crisis, limited availability of land and the high cost of doing business constrained both domestic and foreign investment. There was substantial capital flight owing to uncertainties of the investment climate. These constraints outweighed the positive effects of a stable macroeconomic environment including falling inflation, a stable exchange rate, a falling nominal interest rate and substantial availability of bank credit.

For the 7th Plan, the investment rate needs to increase by 7.0 percentage points of GDP by FY20 to achieve the higher growth path. The FY16 budget starts this investment drive through a number of channels. First, the Annual Development Programme (ADP) is budgeted to increase by 0.7 per cent of GDP in FY16. Second, the budget gives priority to infrastructure investment with special focus on the completion of growth-enhancing transformational projects. Third, it intends to strengthen ADP implementation. Fourth, it seeks to attract private investment by lowering the profit tax rates at the top end. Fifth, it aims at easing the land constraint by putting emphasis on fast tracking special economic zones (SEZs). All these are positive efforts to boost public and private investments.

Yet the effort falls short in a number of areas. The budget does not address the problems of loss-making public enterprises. It does not propose any reform of the state-owned banks and on the contrary allocates more funds to recapitalize them. The delinking of energy prices from the budget is not proposed. There is a mention of increasing investment through the PPP, but no reform is proposed to energize the lethargic PPP performance. A major missed opportunity is the absence of a sound strategy to accelerate the use of the burgeoning foreign aid pipeline. While the profit tax reduction is a positive move, there is no concerted effort to correct the high taxation of the information communication technology (ICT) sector. So, on balance, the budget's long-term investment impact will be considerably softened by the absence of these reforms.

**BOOSTING EXPORTS:** The expansion of exports played a major role in supporting growth during the 6th Plan. Export growth is even more important for the higher GDP growth path of

the 7th Plan. The experience of the 6th Plan shows that while exports performed well, the progress is concentrated on only one product group – readymade garment (RMG). This lack of export diversification is an outcome of a serious anti-export bias of trade policy. The FY16 budget seeks to diversify and push export growth performance by providing similar fiscal incentives to other non-RMG products. The successful implementation of SEZ and power sector expansion programme will also support this.

However, the budget does not make any serious attempt to reduce the anti-export bias of the trade policy. This is again a missed opportunity. The government should recognize that revenue considerations must not govern trade policy outcome. Bangladesh has a comparative advantage in labour intensive exports and the elimination of the anti-export bias of trade policy would help diversify the export base and further accelerate manufacturing growth.

**CONCLUSION:** The FY16 budget proposes several important initiatives to boost public and private investment but there are gaps where reforms are necessary to achieve the investment rate for the higher growth path. In particular, revitalization of the PPP, the rapid use of the aid pipeline and the reduction in the taxation of ICT sector must become an integral part of the government’s investment strategy.

The supplementary duty regime needs a complete overhaul to rationalize the associated trade protection outcome with a view to eliminating the anti-export bias. Reforms to delink public enterprise operations from the budget and convert them to profit-making ventures are essential to generate the additional resources needed to increase public investment.