Shrinking fiscal space: The Achilles heel of Bangladesh development

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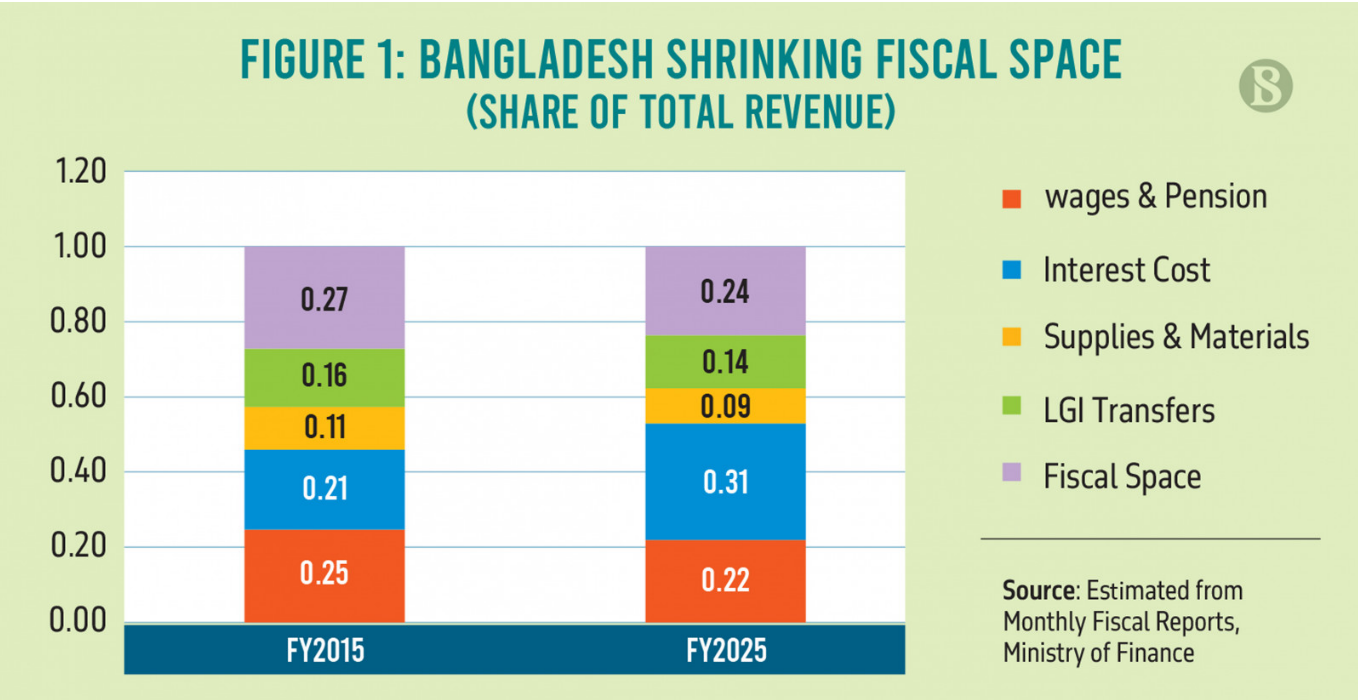
As a consequence of falling revenues as a share of GDP, the Bangladesh fiscal space has been shrinking

As Bangladesh transits towards a much awaited democratically elected national government, the aspiring political party must be acutely aware of the many daunting political, social and economic challenges it faces if it wins the election and takes over the governance of the country. Amongst the multiple economic challenges, arguably the most acute crisis is the management of fiscal policy.

The upcoming policy makers may or may not have a full appreciation of the binding fiscal constraint, which has become the Achilles Heel of Bangladesh development.



Infographics: TBS

Decade-long simmering challenge

The fiscal challenges facing the nation have been simmering for over a decade. Yet, throughout the last 12 years, including the 16-month tenure of the Interim Government, substantive measures to address these constraints have been notably absent. Despite the implementation of a multi-billion dollar, four-year IMF programme in 2023, there remains a distinct lack of tangible improvement in fiscal performance.

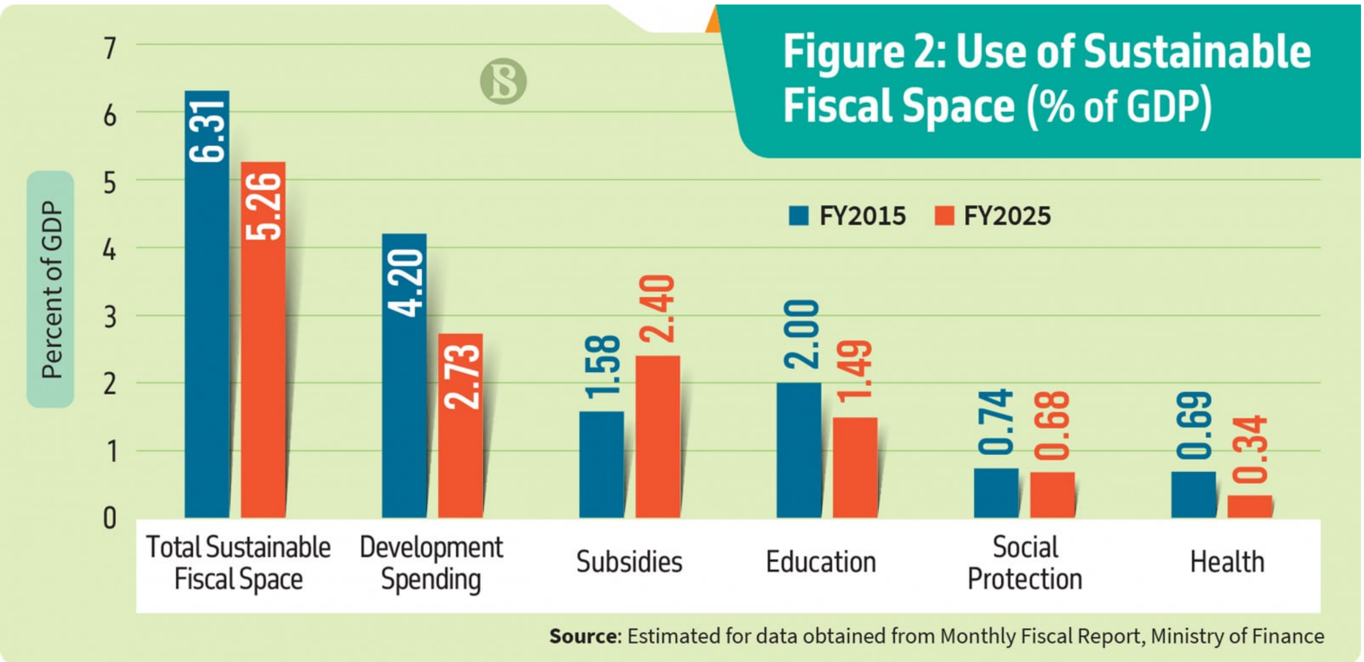
This article aims to provide a summary of the nature and magnitude of the fiscal crisis and identifies the key areas where policy will need to focus.

Bangladesh has one of the lowest tax/GDP ratios in the world and it also has very low non-tax revenue yield. As a result, total revenues are very low. Thus, in FY2015, the tax to GDP ratio was 8.5% and non-tax revenue was 1.1% of GDP, yielding a total revenue of only 9.6% of GDP. This low revenue base has fallen further over the decade since then. In FY2025 the tax to GDP ratio plunged to 6.8% while non-tax revenue fell to 1.0% of GDP, thereby reducing total revenues to a mere 7.8% of GDP.

Shrinking fiscal space

As a consequence of falling revenues as a share of GDP, the Bangladesh fiscal space, defined as total revenue minus fixed spending commitments expressed as a share of GDP, has been shrinking. Figure 1 provides a snapshot of the prevailing fiscal crisis. In FY2015, fixed spending commitments comprising of civil service wages and pensions, interest cost on public debt, supplies and materials spending required for government operation, and transfers to local government institutions (LGIs) to keep them functional absorbed 73% of total revenues, allowing 27% fiscal space for other spending including development, subsidies and social protection. In FY2025, the share of fixed spending increased to 76% of total revenues, leaving an even lower fiscal space amounting to a mere 24%.

Since the fall in total revenues is much larger than the fall in fiscal space, it is apparent that efforts were made to contain the cost of fixed spending. These spending restraints had the biggest impact on materials and supplies, which are in the nature of O&M spending and are likely to have lowered the productivity of the civil service. Efforts were also made to contain the cost of civil service wages and pensions, and its revenue share was lowered from 25% to 22%. However, the efforts to contain the cost of fixed spending to increase fiscal space was more than fully offset by the sharp increase in the interest cost of public debt, which is now the largest spending item, absorbing some 31% of total revenues. This was 22% in FY2015.



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Growing domestic debt a serious concern

In a developing country such as Bangladesh, it is normal to expect some amount of public borrowing from domestic and foreign sources to finance essential spending. The main constraint to such borrowing is usually debt sustainability. Bangladesh traditionally has a good record of keeping fiscal deficit at or below 5% of GDP. This fiscal discipline has served Bangladesh well. However, much of the borrowing is from domestic sources, the cost of which has progressively increased. As a result, while external debt sustainability is not a matter of concern, the ability to finance the growing cost of domestic debt has emerged as a serious fiscal challenge that needs careful monitoring.

Within the limit imposed by debt sustainability considerations, policy makers have some flexibility to increase the total fiscal space, which I call sustainable total fiscal space. This broader concept of fiscal space is estimated by adding fiscal deficit as a share of GDP to the narrow concept of fiscal space as a share of GDP. Good fiscal policy management in the face of resource constraint calls for a sound deployment of this total sustainable fiscal space to serve the development needs of the country.

How has Bangladesh used this broader fiscal space? The results are summarised in Figure 2.

As can be seen, the sustainable fiscal space has fallen by 17% over the past 10 years, mostly owing to revenue shortfall. Reflecting this, the government has cut most of its priority spending items as a share of GDP including development spending, and spending on health, education and social protection. The cutbacks in these high priority spending have been deep, forced by both a fall in sustainable total fiscal space but also unfortunately due to an uncontrolled surge in spending on subsidies, primarily energy subsidy.

Surging subsidy spending

It is certainly very disheartening that subsidy spending has surged from 1.6% of GDP in FY2015 to 2.4% of GDP in FY2025. Alarmingly, subsidy spending now eats up 36% of total tax revenues and is as high as total interest cost of public debt. This is clearly unsustainable and must be contained immediately. A development spending of 2.7% of GDP is inconsistent with a growth oriented fiscal policy. As a result of deep cuts, education spending fell from 2% of GDP in FY2015 to 1.5% of GDP in FY2025, spending on social protection dipped from 0.74% to 0.68% of GDP while spending on health crashed from 0.69% to a meagre 0.34% of GDP over the same periods.

The dismal spending level on human development (health, education and social protection) is inconsistent with any strategy that seeks to lower poverty and reduce income inequality. This spending pattern is at the heart of growing income inequality in Bangladesh. This also has contributed to the reversal of poverty reduction in recent years, in addition to high inflation, fall in real wages and fall in GDP growth rate.

No quick fix

This is clearly a heart-wrenchingly poor fiscal picture. No government can proceed to address the major development challenges of creating jobs, lowering poverty and reducing income inequality without first addressing the fiscal space problem. What is the way out? There are no easy solutions or quick fixes.

But there are a number of realistic and doable policy options. Strong political will, sound strategic judgement, and solid administrative capabilities are needed to develop and implement these policy options. I will briefly summarise the main points. Details can be worked out when the new government takes over.

Major tax reforms a must

The highest priority is to bite the bullet and initiate a major tax reform. This is not an exercise at the margin but calls for a major overhaul of both tax policies and tax administration. On the policy side the main challenge is to modernise the Bangladesh tax structure away from indirect taxes to an income-based tax structure. Trade taxes have to be lowered and reduced to a modest level while personal income tax has to be the main anchor for revenue mobilisation. The productivity and yield of the Value Added Taxes (VAT) should also be enhanced. There is a wealth of research and policy recommendations that are available. The main reforms involve elimination of most tax exemptions, institution of a well-designed property tax system, simplified tax forms and tax laws, and rule based taxation with no scope for discretionary interventions by tax staff.

On the administrative side, the recent decision to separate tax policy from tax collection needs to be fully implemented with professional staff, IT facilities and strong leadership of both tax units. The tax collection unit should be modernised through digital tax collection and payments, and highly selective and productive tax audits.

The objective of the reforms should be to increase the tax to GDP ratio by at least three percentage points over the next 5 years. Strong political will is essential to implement the required tax reforms.

Reform of ailing SOEs

A relatively easy non-tax mobilisation instrument is the reform of the ailing non-financial public enterprise (SOE) sector through corporate governance and pricing reforms. PRI research shows that the non-tax revenue can be increased by 1.5-1.8% of GDP by strengthening SOE financial performance.

Rationalising subsidy

On the spending side, several reforms are needed. The highest priority is to rationalise the subsidy structure with built-in steps to limit subsidy spending to a minimum (no more than 0.5% of GDP). Addressing the energy sector problems is essential to achieve this target. Second, a sea change is needed in increasing allocations for health, education, water and social protection. The target should be to increase spending over the next five years on education to at least 3% of GDP, health to 1% of GDP, water to 2% of GDP and social protection to 2% of GDP. This expenditure restructuring is important to improve human development, increase rural incomes, lower poverty and reduce income inequality. Strong efforts are also needed to strengthen the implementation of these spending through improvements in public financial management, better procurement practices, and through regular M&E.

Prudent deficit financing strategy

Finally, greater attention is needed to work out a prudent deficit financing strategy. The 5% of GDP deficit rule must give way to the objective of securing sustainable deficit financing defined as deficit that minimises the domestic borrowing to only 1% of GDP. Foreign borrowing should be guided by a prudent borrowing strategy that accepts only high return projects at globally competitive cost. These projects will largely consist of those provided by multilateral development banks, with limited use of bilateral loans at comparable financing terms.

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