Implication of the Global Financial Crisis for Domestic Resource Mobilisation - the Bangladesh Experience

Debapriya Bhattacharya

<debapriya.bh@gmail.com>

Mustafizur Rahman

<mustafiz@cpd.org.bd>

CENTRE FOR POLICY DIALOGUE (CPD)
B A N G L A D E S H

a civil society think – tank

Contents

- *Introduction*
- *Salient Features of Revenue Structure of Bangladesh*
- *Revenue impact of the GFC*
- *Government's Action*
- *Lessons Learned*

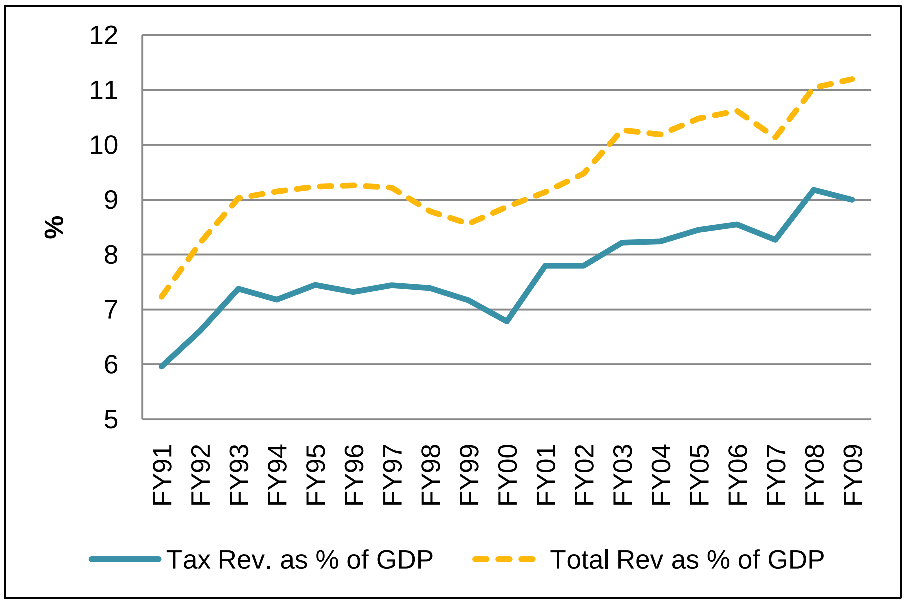
Introduction

- In view of the growing demand for generating adequate resources to confront the manifold developmental tasks facing developing countries, domestic resource mobilisation continues to remain a daunting challenge for on LICs such as Bangladesh.
- As such countries started to graduate from predominantly aid-receiving countries to trading nations, the task of generating resources from domestic sources became ever more difficult.
- Mobilising tax and non-tax revenues, through prudent fiscal policies that balances the purposes of growth, equity and self-reliance was not easy.
- These tensions and challenges were all the more exacerbated because of the ongoing global financial crisis with concomitant implications for domestic resource

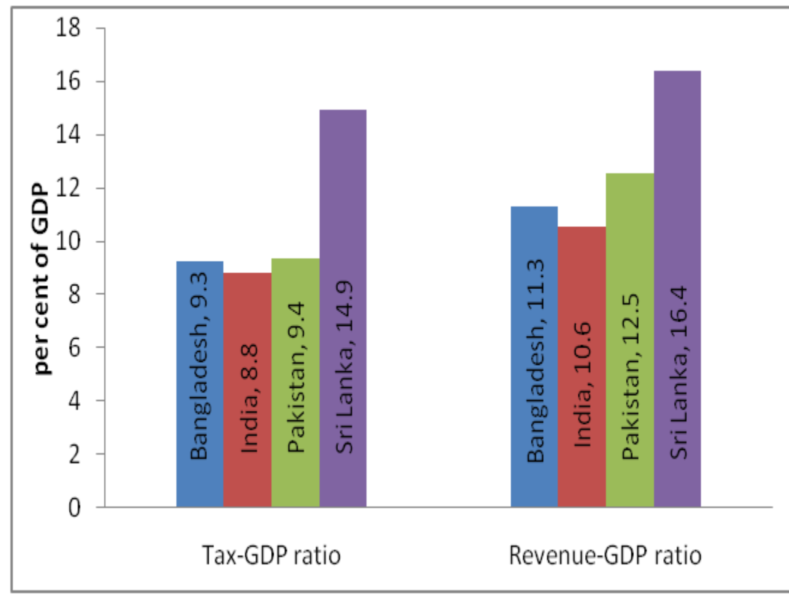
Salient Features of Revenue Structure of Bangladesh

- Revenue-GDP (or tax-GDP) ratio in Bangladesh has remaining unfavorable compared to most of its South Asian neighbours.

REVENUE AS % OF GDP



TAX-GDP AND REVENUE GDP RATIO OF NEIGHBORING COUNTRIES (FY09)



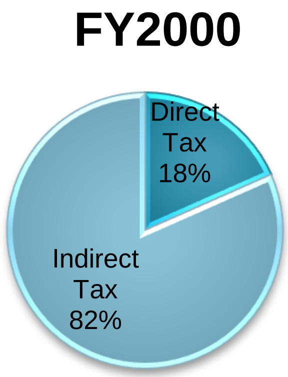
- Revenue-GDP (or tax-GDP) ratio in Bangladesh has remained low (11.2% of GDP in FY08) although slow improvement over the past years is visible (8.21 % of GDP in FY08).

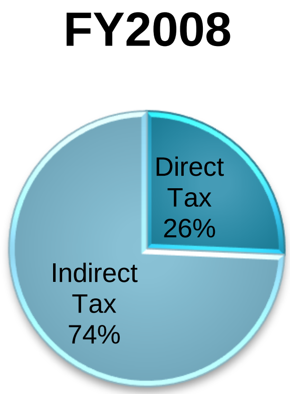
Centre for Policy Dialogue (CPD)

Salient Features of Revenue Structure of Bangladesh

- This improvement happened notwithstanding massive trade liberalisation in 19990s leading to pays loss of import duties.

- Tax revenue has been the major source of government revenue (83% of total revenue in FY08).
- High dependence on indirect tax (from both domestic and import related) sources, which tends to be rather unpredictable, is the major feature of revenue mobilisation.





- Contribution from direct tax has enhanced in the recent past

Total Revenue includes Tax Revenue **plus** dividend and profit, interest, administrative fees and charges, fines, penalties and forfeiture, receipts for services rendered, rents, leases and recoveries, tolls and levies, non-commercial sales, defence receipts, other non-tax revenue and receipts, income from railway and post offices, and capital revenue. **Tax revenue** includes *Direct Tax* (viz. taxes on income and profit, travel tax and others) **plus** *Indirect Tax* (viz. VAT, import duty, excise duty, supplementary duty, narcotics and liquor duty, taxes on vehicles, land revenue, stamp duty, and other taxes and duties).

Salient Features of Revenue Structure of Bangladesh

- Narrow tax base and lack of administrative capacity are the two weakest links that are to be blamed for sluggish revenue mobilisation effort.
- At present only around 10 per cent of potential tax payers pay income tax.
- Existence of a large informal economy also squeezes the opportunity to revert the stagnating revenue effort.
- While reform measures have been introduced time to time to strengthen revenue mobilisation effort, launching of value added tax (VAT) in FY1991-92 and Large Tax-Payer's Unit (LTU) in FY2002-03 are the distinguished milestones of revenue framework in Bangladesh.
- Other institutional reforms include –
    - Income Tax Ordinance 1984
    - Introduction of 'self-assessment system'
    - Use of Electronic Cash Registers (ECR)
    - Provision for Legalising Undisclosed Income (!)

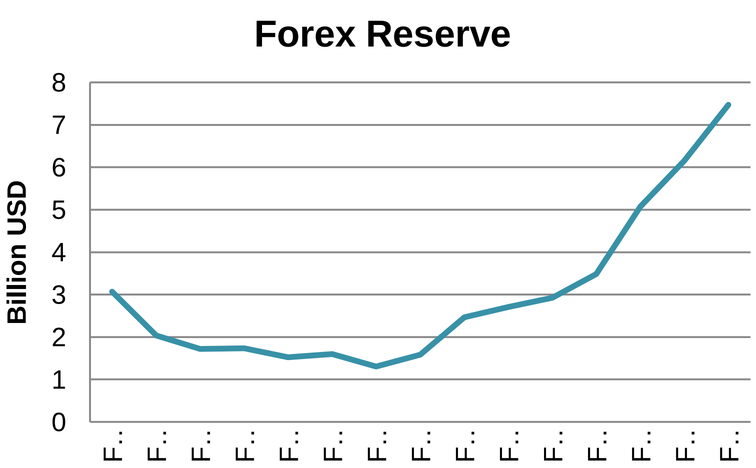
Revenue impact of the GFC

- The GFC, impacted on domestic resource mobilisation in Bangladesh in a number of ways.
- Firstly, Bangladesh's revenue is highly dependent on import duties accounting for 34% of total domestic revenue. The fall in global commodity prices coupled with fall in import demand meant lower custom duty collection and also VAT collection at import stage.
- Secondly, slowdown in economic activities particularly in export-oriented industries meant lower scope for direct tax collection.
- Thirdly, apprehension regarding slow down of foreign resource flow created pressure on need for generating additional domestic resources to finance developmental budget.
- Finally, higher public expenditure demand for enhanced financial/fiscal stimulus and

Centre for Policy Dialogue (CPD)

Revenue impact of the GFC

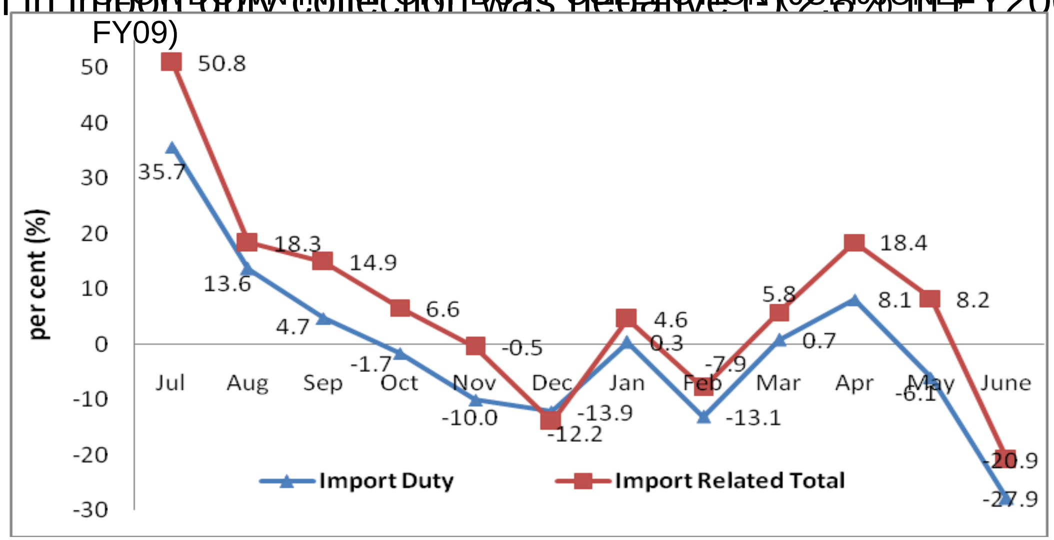
- Imports of the country was significantly lower in FY2008-09 compared to its recent trend (posting only 4% growth compared to 26% growth in the previous year).
- Negative export growth posted by many of the export sectors despite overall moderately high export growth (thanks to resilient performance of the RMG sector) also indicated slowdown of import demand.
- This was also reflected through significantly higher foreign exchange reserves of the country.



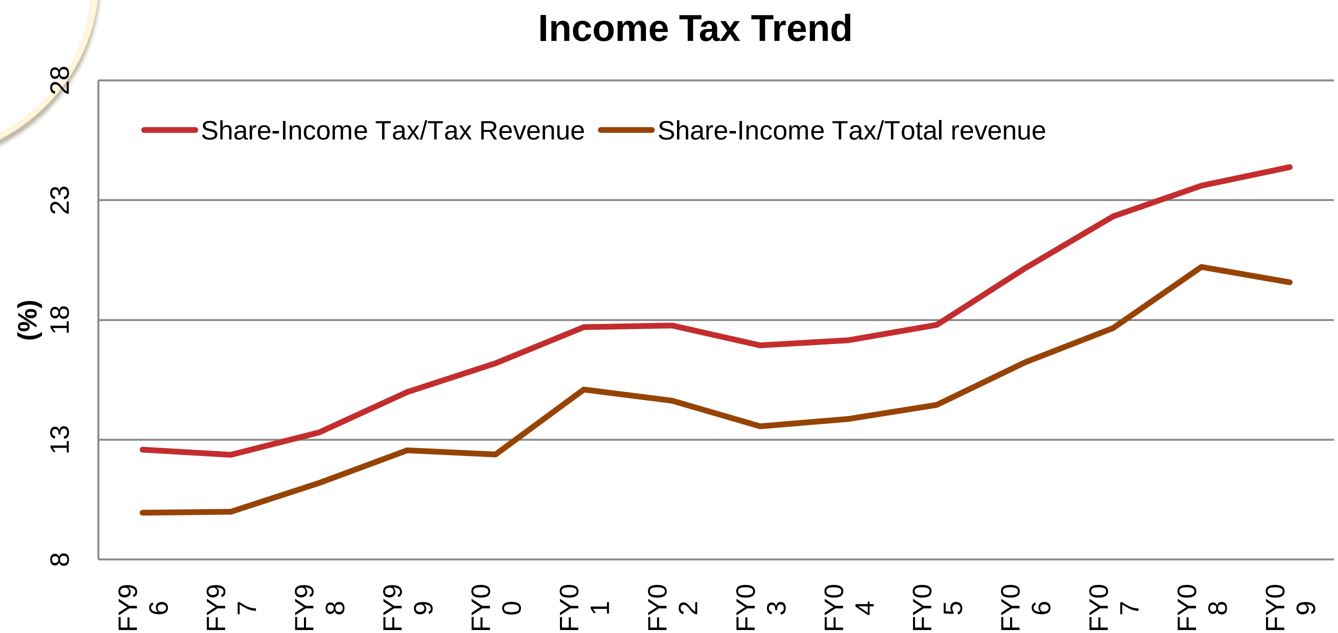
Centre for Policy Dialogue (CPD)

Revenue impact of the GFC

- Owing to the fall in imports, both in value terms and in many instances in volume terms, the government faced formidable challenges in mobilising domestic resources.
- Large shortfall was likely since revenue earnings at the import stage (due to slowdown in imports) faced severe shortages;
  - growth in import duty collection was negative (-)2.8% in FY2008-09.



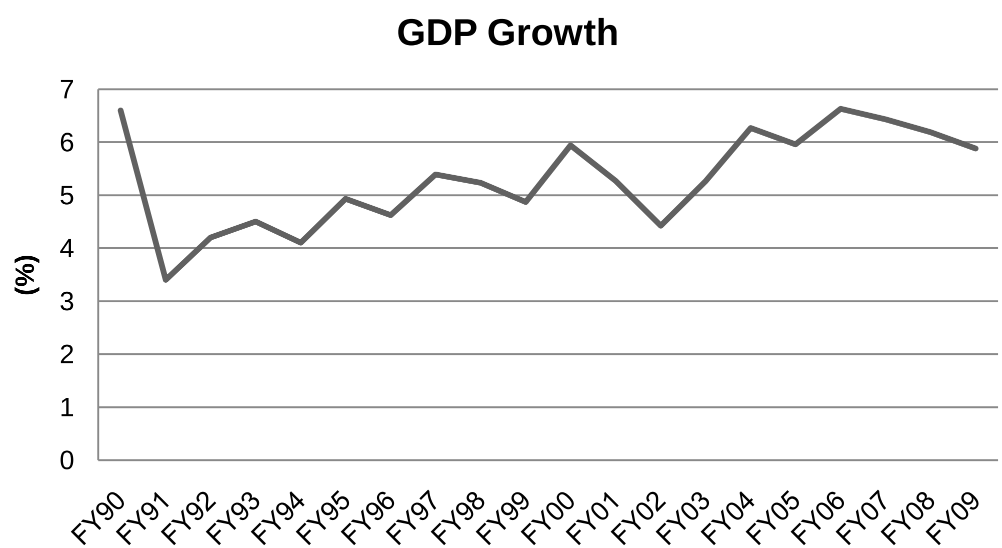
Revenue impact of the GFC



- However, impressive performance of the tax authority in collecting income tax, to compensate for lower revenue collection from imports led to achieving higher than targeted growth of income tax.
- This resulted in lower shortfall in revenue mobilisation.
- The net result was that overall revenue earnings for the fiscal year fell short of target by about 4 per cent.

Revenue impact of the GFC

- Depressed global economy led to lower investments at the local stage, eventually leading to lower than projected GDP growth in FY2008-09.
  - Against the targeted growth of 6.5%, a 5.9% growth was achieved.
- Recent conducted empirical study showed that domestic revenue mobilisation in Bangladesh is significantly determined by the changes in the level of per capita income.
- Thus the adverse impact in terms of potential income growth, in turn negatively affected domestic resource mobilisation.



Centre for Policy Dialogue (CPD)

Government's Action

- The government's immediate reaction was cautious because export sector was able to sustain higher growth rate in spite of the GFC.
- Eventually in April 2009 the FIRST STIMULUS PACKAGE worth around USD 495 million was announced.
- In order to stimulate domestic investment, the central bank decided to cap the commercial lending rate at 13%.
- But no major revenue mobilisation related policy was undertaken.

Government's Action

- A larger SECOND STIMULUS PACKAGE worth almost USD 720 million during the budget for FY2009-10 announced in June 2009.
    - Priority sectors under the package include affected export oriented industries, agriculture SME etc.
- A larger expenditure has been planned comprising significantly higher public investment
- The government has also been forced to consider new safety net measures in view of the GFC such as employment generation programme for returning workers from abroad and training for new labours.
- Foreign aid projection was no better than the usual trend (29% of total deficit financing).
- Thus high expenditure plan has not only relied on a larger projected deficit but will

Government's Action

- The government has to rely more on direct sources for the additional revenue planned for FY2009-10.
- For a change within the indirect sources domestic instruments are to bear the burden of incremental revenue.
- The government has opted for greater administrative effort to enhance the tax base and has also reorganised the duty structure.

- Other measures include -
  - Restructuring the customs duty, where higher taxes have been imposed on luxury goods.
  - Lowering corporate income tax for financial institutions.
  - Widening the tax base by setting up NBR wings in the upazila level and greater use of universal tax assessment system.
  - NBR will carry out new surveys to identify new tax payers in the upazila level.
  - Exemption threshold limit for SME has been increased.

Lessons Learned

- The GFC has exposed the long standing structural weaknesses of revenue mobilisation in Bangladesh.
- The GFC once again reinforced the need for greater emphasis on direct taxes as a source for domestic revenue mobilisation.
- Along with encouraging the government to widen the domestic tax base, the GFC has also reemphasised the need for institutional strengthening towards higher and more effective revenue effort.
- The necessity such an effort is further heightened by the fact that domestic revenue of Bangladesh is non-substitutable with foreign aid, found by the CPD study.

Lessons Learned

- A recent empirical study conducted by the CPD has identified the determinants of domestic revenue mobilisation in Bangladesh –
  - Per capita GDP (with highest influence)
  - Public investment
  - Imports
  - Institutional strengthening i.e. introduction of VAT and LTU

Centre for Policy Dialogue (CPD)

Thank You