SYDNEY POLICY & ANALYSIS CENTRE

SPAC Briefing Note 04

Bangladesh Budget Review 2024:

Bangladesh's Fiscal Policy Settings Could Be Better Calibrated to Address Current Economic Woes

June 2024

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Bangladesh Budget Review 2024: Bangladesh's Fiscal Policy Settings Could Be Better Calibrated to Address Current Economic Woes

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1. Introduction

On 6 June, Mr Abul Hassan Mahmood Ali became the third finance minister since 2009 to present the budget.

The budget was presented when Bangladesh had been facing significant stress due to external and internal factors. These factors have led to macroeconomic instability, depleted foreign exchange reserves, inflation, and challenges in managing external debt. The country's GDP growth has been weakening, and private sector investment growth and employment creation have not been satisfactory. Conflicting monetary and fiscal policies, high non-performing loans, and concerns about the country's capacity to service its debt have further complicated the economic situation.

Using the final budget outcomes since 2009-10 as well as the projections from the latest budget, this Policy Briefing Note charts the evolution of fiscal policy settings of the government of Prime Minister Sheikh Hasina over nearly two decades.

Analysis shows that the fiscal policy settings became expansionary well before the pandemic and other global shocks. Further, budget deficits are not projected to narrow despite projections of record revenue mobilisation.

Considering the historical trend of revenue underperformance, either worse budget deficits will have to be financed, or the government will have to pare back expenditures. The budget sets the government up for an unenviable choice.

This Note suggests that the new Finance Minister has missed an opportunity to implement a better fiscal policy built around a more realistic revenue target and commensurate cuts to expenditure. Instead, the lack of credibility around the current fiscal stance and uncertainty over future course corrections can exacerbate the current economic woes.

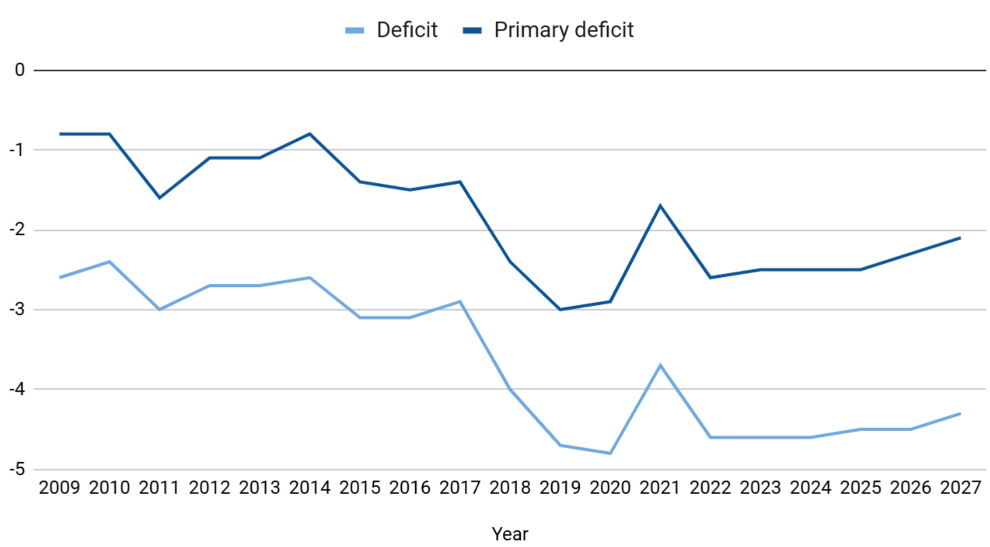
2. Macro-fiscal Observations

2.1) The budget deficit widened in the late 2010s and is set to remain so

Fiscal policy settings in Bangladesh became expansionary in the second half of the 2010s, well before the COVID-19 pandemic and geopolitical shocks such as wars in Europe and the Middle East.

Until the fiscal year 2016-17, the Bangladesh government maintained a budget deficit of 2.5-3% of its Gross Domestic Product (GDP). Subsequently, this deficit expanded to 4.7% of GDP over the next two years. Projections indicate that deficits are anticipated to persist at over 4.3% of GDP up to the fiscal year 2026-27. Chart 1 illustrates this.

Chart 1: Deficit and primary deficit, % of GDP



A similar trend is visible in the primary deficit, which, by excluding interest payments, provides a better indication of the fiscal stance. An increasing primary deficit suggests that the government is stimulating demand within the economy.

While this can spur economic activities when there is excess capacity in the economy, it may further raise prices during periods of heightened inflation. Notably, the primary deficit widened even prior to the onset of the pandemic and is anticipated to remain worse than levels observed in the first half of the 2010s.

2.2) Weak revenue collection is not the main reason for worsening budget deficit

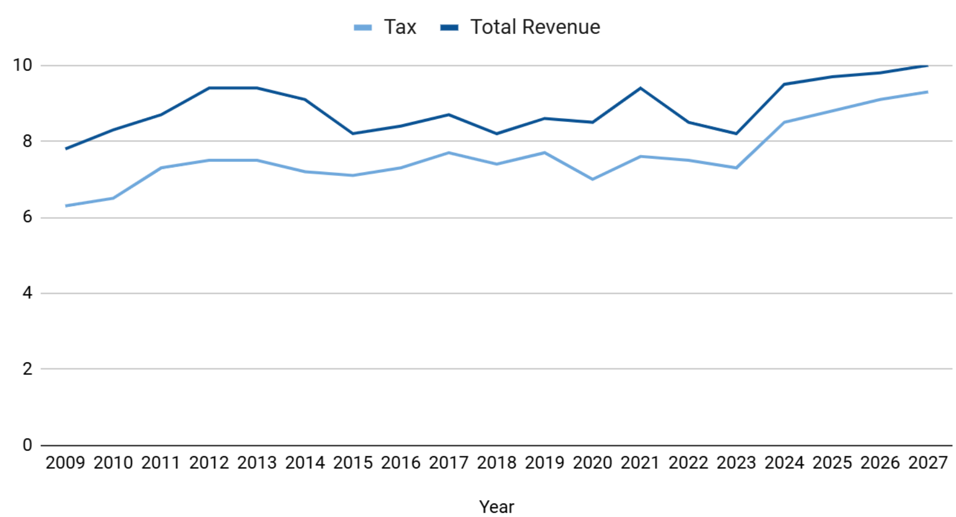
Bangladesh has a low revenue-to-GDP ratio compared to its peers. Therefore, it is possible to assume that the widening budget deficit is the result of weak revenue collection.

However, analysis shows that the budget deficit did not widen in the late 2010s because of declining revenue, as total revenue hovered around 8.5% of GDP and tax revenue around 7.5% of GDP, as illustrated in Chart 2.

The proposed national budget for the 2024-2025 fiscal year has set a revenue collection target of 5,41,000 crore takas, which accounts for 9.7% of the GDP. It has been proposed that 4,80,000 crore takas would be collected through the National Board of Revenue (NBR), and the rest of 61,000 crore takas would be collected from other sources.

Furthermore, total revenue and tax revenue are both projected to rise to record levels relative to GDP by 2026-27 (Chart 2).

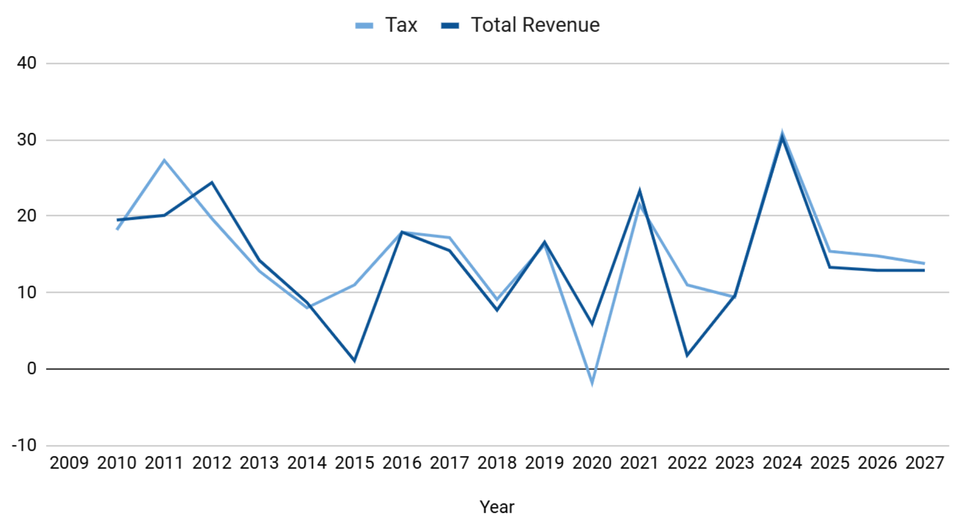
Chart 2: Tax and total revenue, % of GDP



To achieve these ambitious revenue targets, substantial growth in both overall revenue and tax revenue over three consecutive years will be necessary, a feat that Bangladesh has not managed to accomplish in recent times (see Chart 3).

This task will be particularly challenging given the current economic conditions, which are characterised by a slowdown in economic activities attributed to increasing interest rates and a limited supply of raw materials and capital machinery due to restrictions on imports.

Chart 3: Tax and total revenue growth, %



Bangladesh has a history of underachieving revenue collection, with actual collections usually failing to meet the announced targets set during budget planning. The slowdown of economic activities coupled with Bangladesh's historic problems in achieving revenue collection targets means that revenue collection projections are likely to be missed.

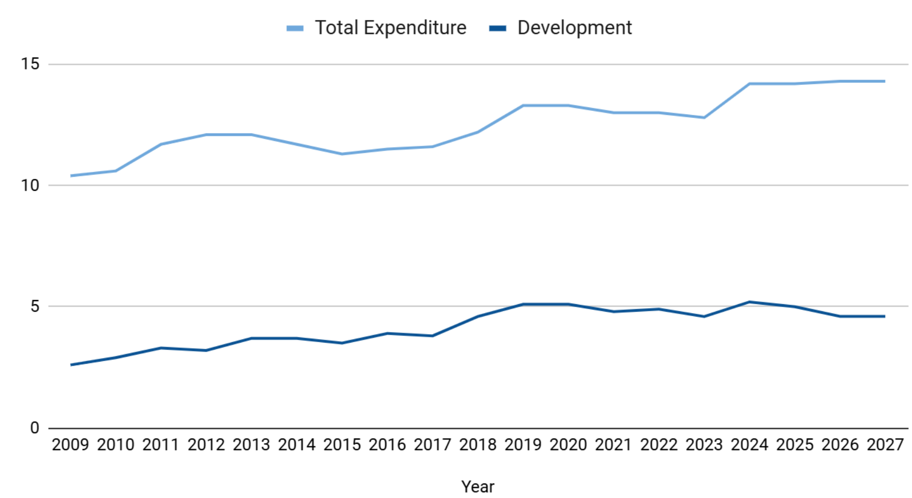
The estimated deficit in the proposed FY 2024–25 budget is 2,56,000 crore takas, which is 4.6% of GDP. To finance the proposed budget deficit, 1,60,900 crore takas will be collected from domestic sources and 95,100 crore takas from foreign sources.

If revenue collections do not reach the target, the government will be faced with the difficult choice of either funding even larger budget deficits than originally anticipated or implementing expenditure cuts.

2.3) Rising expenditures are leading to worsening budget deficits

The widening budget deficit before the pandemic reflected a nearly 1.7% GDP increase in total expenditure, of which 1.3 percentage points were in development expenditure. This is illustrated in Chart 4.

Chart 4: Total and development expenditure, % of GDP



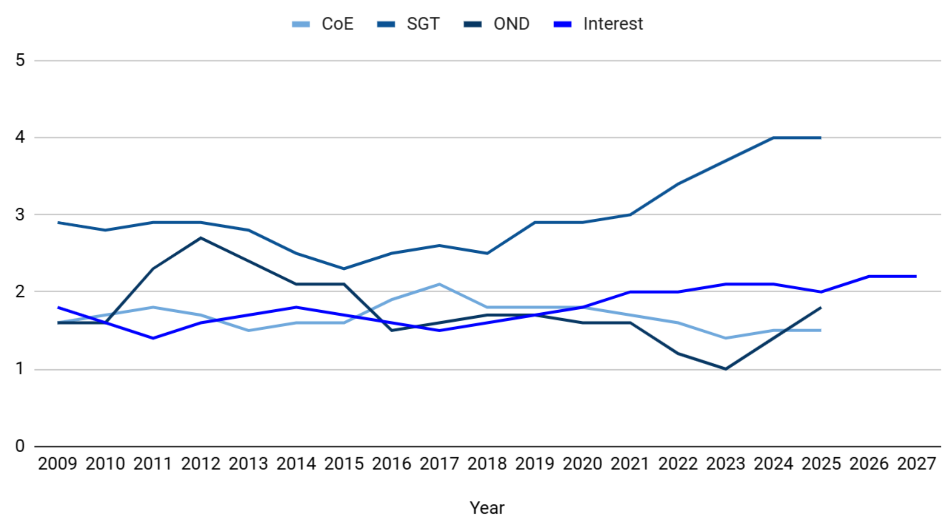
The worsening budget deficits projected for the coming years are not expected to be primarily driven by development expenditures. Development expenditures accounted for approximately 3-4% of the GDP in the early 2010s, rising to around 5% in recent years. Projections indicate a slight decline in development expenditures relative to GDP in the years ahead.

Chart 5 demonstrates that subsidies, grants, and transfers have recently increased and are expected to continue to remain at elevated levels relative to GDP. Expenditure on these items accounted for 2.5-3% of GDP until 2020-21 but has since risen to 4% of GDP.

In comparison, other expenditure items remain relatively low when measured against GDP using historical data. Chart 6 presents the same information but in relation to total revenue collections.

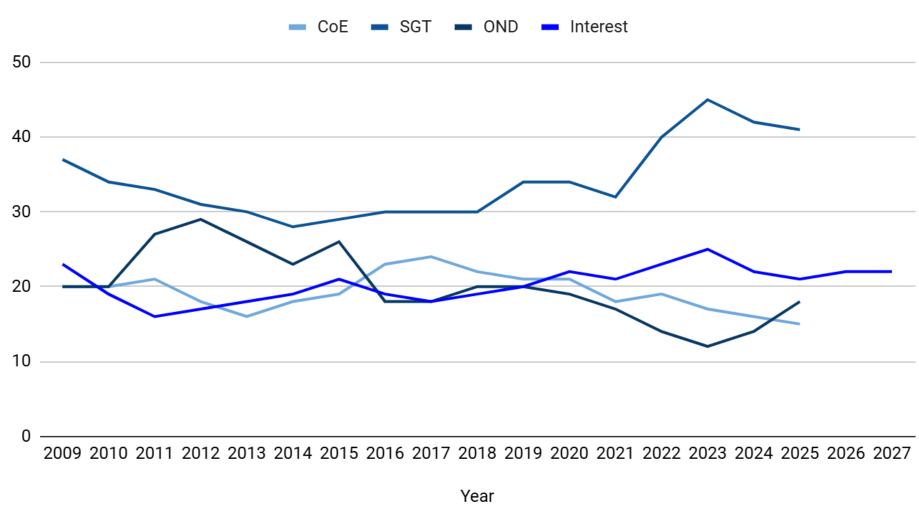
In essence, the consistently high budget deficits over the projection horizon are primarily attributed to increased subsidies, grants, and transfers expenditures.

Chart 5: Non-development expenditure, % of GDP



* CoE = Compensation of employees (public service wage bill); SGT = Subsidies, grants and transfer; OND = Other non-development expenditure (mainly the purchase of goods and services).

Chart 6: Non-development expenditure, % of revenue



* CoE = Compensation of employees (public service wage bill); SGT = Subsidies, grants and transfer; OND = Other non-development expenditure (mainly the purchase of goods and services).

If revenue collections fall short and the government were to cut expenditure, it would need to pare back either development expenditure or subsidies, grants and transfers.

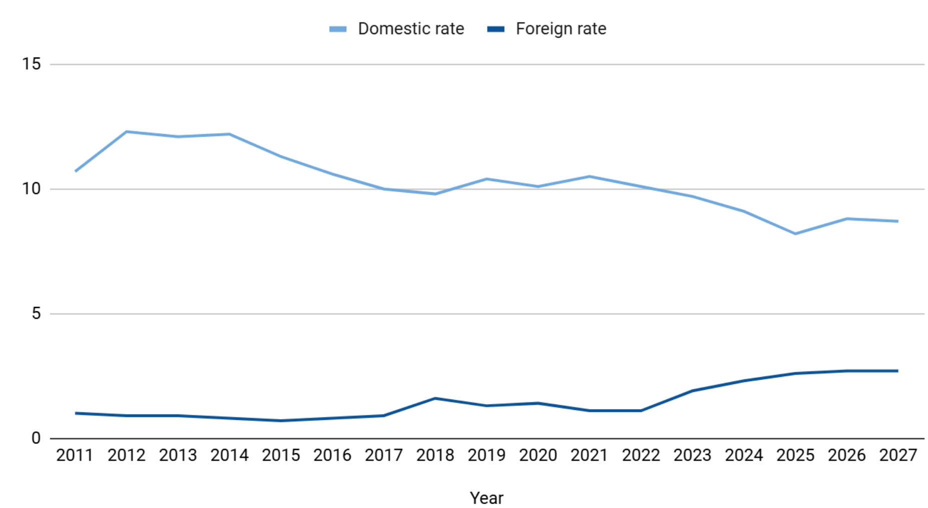
This will be a difficult choice. Cutting development expenditures can hurt future growth prospects. Subsidies, grants, and transfer payments, on the other hand, reflect public policy rationales (for example, supporting the vulnerable segments of the population) or political economy considerations (for example, energy subsidies) that make it difficult to cut these expenditures.

2.4) Financing options remain limited

Meanwhile, the government's financing options are limited. One option is to borrow from external sources. Although interest rates on foreign debt are rising, they are still far lower than the interest rates on domestic debt (Chart 7).

External debt has become a relatively more important source of financing in recent years. However, external debt carries significant exchange rate risks as depreciation of the taka would mean a higher debt service burden.

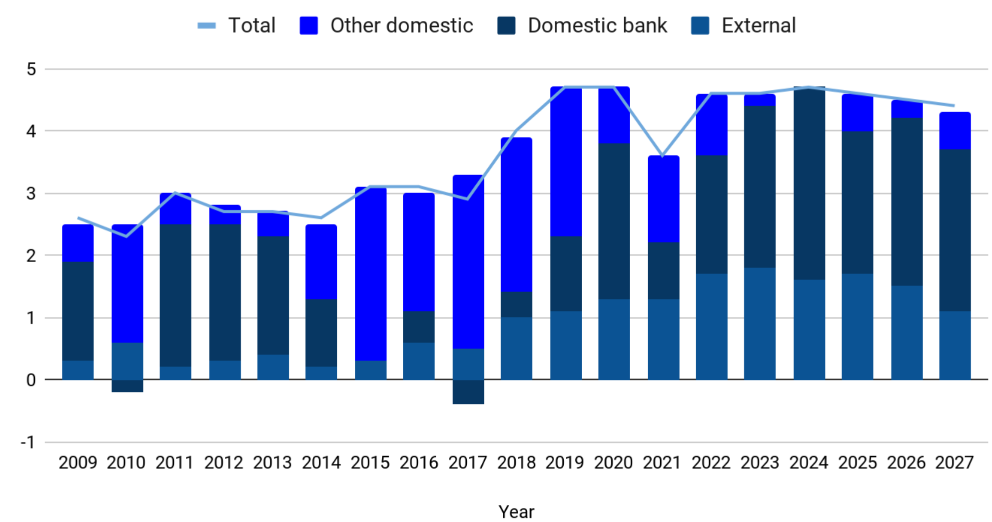
Chart 7: Implied interest rates, %



The widening budget deficits of the late 2010s were financed by selling National Savings Certificates to households. These instruments are relatively costly, and many of the earlier certificates are now maturing. The government has, therefore, increasingly opted for the third option of borrowing from domestic banks, which are now the main source of financing. Chart 8 shows the evolving financing mix over the years.

Against the backdrop of a weak banking system that is reeling from a large stock of non- performing loans, government borrowing from the banking sector could crowd out private investment, hurting the longer-term growth potential of the economy. Genuine banking and capital market reform would allow for a deeper pool of financing sources for the budget deficit as well as options for households to channel their savings into productive investment. However, this does not appear to be on the cards.

Chart 8: Financing, % of GDP



The current fiscal policy stance includes a persistent deficit despite record-high revenue projections. The lack of credibility around these revenue projections creates uncertainty over how the government will finance a worse budget deficit or which expenditures will be cut. This uncertainty is likely to exacerbate the current macroeconomic challenges.

An alternative scenario with a more credible revenue forecast and reduced expenditures could have inspired confidence in the government's ability to manage the macroeconomy. However, that opportunity appears to have been lost.

3. Recommendations

Based on the observations, we present the following recommendations for the Bangladesh government to calibrate its fiscal policy better to address current economic challenges:

- Increase the efficiency of the tax and revenue collection process, and broadening the tax base should be prioritised instead of increasing tax rates to fund the expenditure programs. This will allow the government to meet the revenue targets.

- Impose stricter control and monitoring mechanisms with regular reviews and adjustments to prevent the budget deficit from widening. This will allow the government to manage the primary deficit carefully, thereby aligning fiscal and monetary policy goals during the current period of high inflation.

- Preserve development expenditures from any cuts as much as possible, particularly those in education and healthcare, as well as infrastructure projects with transparent financing. These investments are crucial for long-term economic growth.

- Scrutinise subsidies, grants and transfers and preserve those expenditures where the beneficiaries are the vulnerable segments of the population and reduce those expenditures that benefit the relatively well-off.

- Initiate genuine financial and capital market reforms to create a deeper pool of financing sources for the budget deficit. This will also reduce macroeconomic vulnerabilities and enhance long-term growth prospects by enabling households to channel their savings into productive investments.

Data sources

Fiscal indicators: Budget at a Glance from 2009-10 to 2024-25 and the Medium Term Macroeconomic Policy Statement from 2020-21 to 2024-25, all availed from the Ministry of Finance website.

Nominal GDP: Bangladesh Bureau of Statistics National Accounts (earlier series spliced onto the latest release to create a longer time series).

Data is available upon request.

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