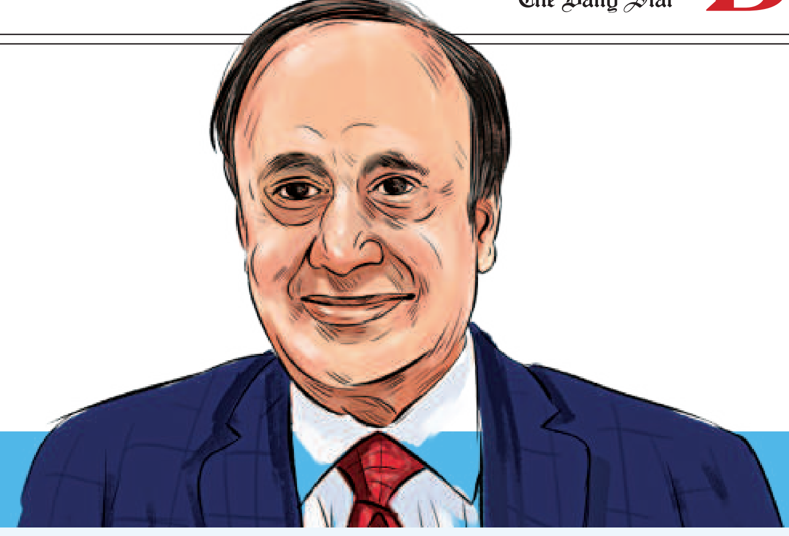
It's time to correct FISCAL STANCE



Sadiq Ahmed, vice-chairman of PRI

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The government has not addressed the stability issue through its fiscal policy for two years in a row although the economy is in turmoil owing to both external and internal pressures. A noted economist, however, thinks it can bring the situation under better control through the budget in the next fiscal year beginning on July 1.

Sadiq Ahmed, vice-chairman of the Policy Research Institute of Bangladesh (PRI), a Dhaka-based think-tank, said he does not think the government can compromise on stabilisation at this stage.

"In the last two to three years, they did not use the budget for that. And that was a mistake. The government has done the monetary correction and the exchange rate correction, and now it will have to correct the fiscal stance."

For the past two years, Bangladesh has been facing serious macroeconomic instability reflected in higher inflation, depletion of foreign currency reserves, strain on the exchange rate, a decline in capital inflows, and pressure on the budget.

In response, the government has devalued the currency, imposed import controls, tightened public spending, and very recently allowed interest rates to go up.

But Ahmed thinks the full range of demand management policies necessary to reduce demand and stabilise the economy has not been made yet. "Consequently, macroeconomic imbalances continue to persist."

While the flexibility of the interest rate has already reduced the demand for credits and lowered the demand pressure on foreign exchange, the impact on the reduction in the inflation rate has been less visible.

This is partly because of the time lag, but also because the demand pressure, emanating from fiscal deficits, has not been addressed, the former senior official of the World Bank said.

Despite significant cutbacks in annual development spending, the budget deficit remains stubbornly high at around 5 percent of gross domestic product (GDP) owing to subsidies and shortfalls in revenue mobilisation.

"While a fiscal deficit of 5 percent of GDP may not appear high in a normal year, in the present context of high inflation and pressure on the balance of payments, there is a need to contain it to 2-3 percent."

Ahmed said the main elements of the budget strategy should be to reduce fiscal deficit significantly to lower aggregate demand. This demand reduction should be achieved in a way that it does not compromise the future growth prospect or hurt equity.

For this to happen, the strategy will involve raising tax revenues through effective tax reforms, increasing the profitability of state-run enterprises (SoEs) through corporate governance and pricing reforms, reducing subsidies, and raising spending on human development and social protection.

The PRI has carried out considerable research on the tax reform agenda. Hence, he said, the main elements of the tax reform are well-known and have been presented in public forums and shared with the government many times.

These include separating tax planning and tax policy from tax collection; strengthening both units with autonomy, professional management and quality staffing; digitalising tax assessment and collection thereby eliminating the interface between taxpayers and the tax collector; simplifying tax filing by eliminating the income, expenditure and wealth reconciliation; selective and productive audits done by professional auditors; implementing the 2012 VAT law; and introducing a modern property tax system.

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"While the full implementation of the tax modernisation plan will take two to three years, an early start can be made in the FY25 national budget and these can have substantial positive revenue effects," Ahmed said.

He said there is no shortcut to digitalisation of the tax system and there is no reason this cannot be done within the next twelve to eighteen months.

"I am confident if the government implements the above measures and the VAT law, you will get revenue equal to 1.2 percent of GDP in nine months to one year."

The economist said the government has invested heavily in SoEs and most of them suffer from operating losses. As a result, as against a book value of total non-financial SoE assets of 17 percent of GDP in FY2021, profits were a mere 0.6 percent of GDP.

"A 10-12 percent financial rate of return should yield profits equivalent to 1.8-2 percent of GDP. It is conservatively assumed that the government can raise an additional surplus of 0.3 percent of GDP from SoEs in FY25."

He said the government can't afford to neglect the fiscal adjustment agenda anymore. "I know bringing about fiscal reforms is politically difficult. But all reforms are politically difficult."

To control inflation, the government has finally agreed that the interest rate will be market-based. Ahmed said: "That's a very good policy and a forward-looking one. It's better late than never."

In recent months there were multiple exchange rates from as low as Tk 110 to as high as Tk 127 per USD, he said. Nevertheless, it was clear that very few transactions were happening at Tk 110.

Ahmed's recommendation is to go for full flexibility to manage the exchange rate and he called the crawling peg as not a meaningful concept. "The central bank can't keep the exchange rate at any fixed number or even a narrow band as it does not have the reserve cover to back it up. It can, however, influence the market rate by using monetary and fiscal policy instruments."

Cutting down the annual development programme (ADP) to a large extent will not be desirable as this will compromise the development agenda. The fiscal adjustment has to be addressed through some meaningful reforms, he said.

"Frankly speaking, there is not much scope to cut public expenditure. The only area where spending can be adjusted is to reduce subsidies on energy, exports and remittances," Ahmed said.

With a market based exchange rate, there is no need for export and remittance subsidies. Regarding energy subsidies, the government does not have the fiscal space to carry those subsidies. A subsidy on fossil fuel consumption is also inconsistent with the carbon reduction agenda. But, by and large, in order to meet the development objectives of growth acceleration and poverty reduction, the government will have to raise more resources.

The problem with Bangladesh is that it relies heavily on indirect taxes, especially import taxes. On the contrary, all developed countries raise 70 to 80 percent of the taxes through income taxes.

In Bangladesh, the capacity to pay has grown tremendously compared to the early 1990s when per capita income was $300 against $2,800 currently.

"Then why is the personal income tax to GDP ratio only 1.3 percent, one of the lowest in the world?" questioned Ahmed.

"This is because the rich don't pay taxes. The system functions in such a way that they can skip the taxes or reach negotiated settlements. The tax system has to be overhauled."

Reduce cost of doing business to facilitate investment

Businesspeople urge govt to ensure conducive ecosystem

Global FDI amounted to $1.3 trillion in 2022, with nearly half being made in Asia. South Asia saw an overall 7 percent increase, but Bangladesh witnessed a decline

SUKANTA HALDER

Businesspeople in Bangladesh have called for improving the ease of doing business and reducing the cost of production to establish a conducive trade and investment ecosystem.

If these issues are addressed, more foreign direct investment (FDI) will flow into the country and local entrepreneurs will get the opportunity to grow further, they said.

The major challenges for the national budget for the fiscal year 2024-25 will be controlling inflation, increasing the foreign exchange reserves, exports, and the tax-GDP ratio, and bringing reforms in the banking sector.

Along with that, there are also challenges related to reforming fiscal policy.

Experts said the allocation for the government's open market sales programme should go up, and Bangladeshi expatriates should be incentivised to invest in the country, not only in real estate but also in stocks and banks.

"Additionally, the customs, tax and VAT systems have to be automated and if the National Logistics Development Policy is implemented, it will help cut the cost of doing business," said Mahbubul Alam, president of the Federation of Bangladesh Chambers of Commerce and Industry.

Emphasis should also be placed so that the interest rate of bank loans does not go up. This is because if the interest rate climbs, industrialisation and investment in the country will be hampered.

"It is also necessary to reduce the advance income tax rate in phases to reduce the cost of doing business," Alam added.

The top business leader in Bangladesh said the central bank will have to monitor all banks to ensure their compliance with the new exchange rate system.

He suggested that there should be instructions or plans in the budget for ensuring uninterrupted and quality gas and electricity supply. Also, it is important to bring down inflation, which has stayed above 9 percent for nearly two years.

Zaved Akhtar, president of the Foreign Investors' Chamber of Commerce and Industry, said FDI contribution to the country's GDP is inadequate and should be improved.

"We are getting significantly below our fair share, whether we are comparing with global benchmarks or even just South Asia. We must ensure that we build Bangladesh as a preferred destination for investment."

According to the latest United Nations Trade and Development report, global FDI amounted to $1.3 trillion in 2022, with nearly half being made in Asia. South Asia saw an overall 7 percent increase, but Bangladesh saw a decline.

FDI in Bangladesh amounted to just 0.4 percent of the country's GDP in 2022 while the ratio was 1.5 percent in India and 4.4 percent in Vietnam.

In 2023, FDI to Bangladesh snapped its rising trend. Central bank data showed last week that the country received $3 billion in FDI last year, a decrease of 14 percent from $3.5 billion in 2022.

Akhter said multiple factors work against the country when it comes to attracting FDI. This is because it is difficult to onboard investors as setting up their ventures entails securing 150 approvals from 23 departments while the country's uncompetitive and complicated tax structure is also discouraging.

Additionally, Bangladesh has an underdeveloped legal system that fails to respect alternative dispute resolution and international arbitration outcomes.

Predictability and planning of future tax rates are fundamental components of any long-term business planning, especially for foreign investment, he said while adding that improving tax predictability and facilitating effective tax planning is essential for implementing tax rates on a forward-looking basis.

"Moreover, a few provisions in the current tax regime are creating an unfair tax burden on businesses. Such rules are adversely impacting the growth of investment and FDI," Akhter said.

This can be best illustrated by how treating disregarded expenses as separate taxable income imposes an unjust additional tax liability on businesses, thereby raising their operational costs, he added.

Ashraf Ahmed, president of the Dhaka Chamber of Commerce and Industry, said first, Bangladesh may have issues with crop harvests and a lower production may require increased imports, for which it must pay in foreign currencies.

Second, if inflation remains high, a portion of the marginal poor slides below the poverty line and can no longer afford sufficient food.

As a solution to the first case, Ahmed said Bangladesh needs to maintain an adequate food supply, which it already does. "But these need to be released into the market in a timely manner to maintain supply and prices."

He said allowing the market to determine the foreign exchange rate is vital to stabilise the foreign exchange market.

Deen Islam, associate professor of the economics department at the University of Dhaka, said though the Bangladesh Bank recently announced a crawling peg to set the exchange rate, it has been observed that the central bank has failed to follow through with its announced policies in the past.

If the BB continues to tightly manage the exchange rate, a speculative bubble will form, leading to greater uncertainty, which could have serious negative consequences on private investment.

Therefore, the government could provide additional incentives to Bangladeshi expatriates to invest in the country, not only in real estate but also in the stock market and banks.

"For this, it is important to ensure good governance in both the banking sector and the stock market."

Due to higher inflation for the past two years, people's real purchasing power has been falling, said Mohammad Abdur Razzaque, chairman of the Research and Policy Integration for Development.

Interest rates are rising. As a result, trading activities will shrink, and employment will be affected. And the decrease in the income of ordinary people means that food insecurity will be created, he added.

"Therefore, under the circumstances, the allocation for open market sales should be increased."

Besides, the expansion of the annual development programme should be carefully considered as some cost reductions could be made from mega projects, Razzaque said.