

FISCAL FIDUCIARY: EMBEDDED EDGES
A Rapid Assessment of National Budget 2008-09



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Acknowledgement

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I. INTRODUCTION

What went wrong? It is, of course, part of the human psyche to turn first to the “evil man” theory for potentially satisfying explanation, modified as appropriate by “stupid man” amendments. And it would, indeed, offer grounds for short-term optimism if the policy disasters we have witnessed could be imputed squarely to either the deliberate machinations of corrupt politicians or the folly of the unwise. We fear, however, that such an imputation would simply be escapism. The election of neither more honest nor more enlightened politicians will solve our difficulties.

- *James Buchanan and Richard Wagner, Democracy in Deficit (1977).*

The budget for 2008-2009 resuscitates, yet unwelcomingly, Buchanan and Wagner, who are worshipped public finance theoreticians of the current economic policymaking the world over, including Bangladesh. These quoted words written in the context of high inflation and high unemployment with increasing poverty ring as the national budget, supposedly economic manifestation of political mandate, lands in twice consecutively by a non-elected government. It times up with rise in poverty, inequality, inflation, food price, fiscal deficit, trade deficit, macroeconomic imbalances, investment sloth, and output contraction. The budget keeps up with the continuity of liberalisation, privatisation and deregulation of successive governments.

The present government took the office in the backdrop of a chaos created by feuding political parties. The context of the takeover ensued blaming the politicians in last one-and-half year, but people of the country have been disenchanted with apparently permanent and increasing inflation with standard of living reaching at its abysmal. The **economic outcome points out the missing linkage or interdependence between the politics and economics**. This necessary linkage or interdependence between the basic political structure of society and the economic policymaking is the central criteria for social welfare maximization.

Concurrent failure of ADP implementation, subsequent cut down of development programme, little attention of increasing efficiency of ADP implementation, shocks like oil and food price-hike together with lack of transparency and accountability of budgeting process has led the fiscal management unsustainable as reflected from increasing current expenditure while reducing the development expenditure.

This in couple with lack of coherence between the macro rules, expenditure rules and budgeting process imply that long term macro economic goals are not being reflected in the decision making process as the current fiscal has ended up with lower growth and higher

inflation as opposed to what it has been predicted by the government at the outset of the current fiscal. Moreover, slowing down of investment – both public and private – as a percentage of GDP that has been perceived since fiscal 2006-07 is another cause of concern, indicating that growth path likely to see instability in near future with increasing unemployment and inflation.

In such a backdrop, the finance adviser has announced yet another budget, which is misleadingly seen to be gigantic in figures, announcing some cushions to respite the mass consumers from the repulsions of inflation. How this extra budgetary support would alleviate the consumers who have been contorted by the price spiral that is one question. But how the budget would be financed remains ambiguous. Moreover, the measures proposed seems to show the signs of fiscal mismanagement, as the economy has already laboured under continuing and increasing budget deficits, high unemployment, apparently permanent and perhaps increasing inflation, and accompanying disenchantment with the socio-political order.

This raises the fundamental question of the fiduciary responsibility of government. The social contract, as expressed in the Constitution, between the citizen and the state, warrants extremely loyal to the person to whom he owes the duty (the "principal" i.e. the citizens): the government must not put its personal interests before the duty ascribed by the citizens. The fiduciary responsibilities regarding the custody of public moneys, their payment and the withdrawal from the Consolidated Fund or, as the case may be, the Public Account of the Republic, and matters connected with or ancillary matters are ascribed in Article – 82 of Constitution of Bangladesh.

II. MACROECONOMIC IMPLICATIONS

The present caretaker government has proposed a budget amounting Tk 99,962 crore for the fiscal 2008-09, which is 16.1 % higher than the revised budget of last year and 25.6 % higher than the actual budget of the fiscal year (FY) 2007-08 (the revised estimate is increased by Tk 6471 crore of the actual budget estimated). The proposed revenue is estimated at TK69382 crore, up by 14.6% of the revised budget of the fiscal 2007-08. The revenue of the revised budget is set at TK 60539 crore as against Tk 57301 crore. The proposed budget deficit is 5% of the GDP. Of this 2.2% of the GDP will be financed from foreign resources while the rest 2.8% will be borrowed from the domestic sources (Table – 1).

Table 1: Budget of 2008-09 and Revised Budget 2007-08 at a Glance

(In Crore Taka)

Description	Budget 2008-2009	Revised Budget 2007-2008	Budget 2007-2008	Percentage change from revised budget 2007-2008
Revenue and Foreign grants				
Revenue	69382	60539	57301	5.35
Tax Revenue	56789	48012	43850	8.67
Non Tax Revenue	12593	12527	11463	8.49
Foreign Grants	6346	4388	4255	3.03
Expenditure				
Non-Development Expenditure	66753	57425	53852	6.22
Development Expenditure	29549	24350	29549	-21.35
Employment Generation and Development Program	2171	1046	1511	-44.45
ADP	25600	22500	26500	-17.77
Total Expenditure	99962	93608	87137	6.91

Overall deficit (including grants)	-24234	-28679	-25581	10.80
As % of GDP	-3.95	-5.36	-4.82	10.07
Overall deficit(excluding grants)	-30580	-33069	-29836	9.77
As % of GDP	-4.99	-6.18	-5.63	8.89

Lacking Long-run Vision

The present budget tries to address some of the immediate issues like price hike and subsidy to oil and food. However, like the previous one, the budget for the fiscal 2008-09 lacks long run vision of the economy. What is missing in the budget is the linkage between tackling the short term problem and maintenance of long term goal of the economy of spurring growth to generate employment and to reduce poverty. One opportunistic explanation could be that the finance adviser has given attention to immediate issues through available resources to tame the exasperation of the people instead of considering overall macroeconomic momentum since the present government has announced to end its tenure by the end of December 2008. The alternative explanation could be that like the preceding budget the proposed one also lacks long run vision.

What is conspicuous from the present budget is that the government has set a budget deficit that exceeds the total development expenditure for the given fiscal. It means that government revenue is not sufficient to meet up the revenue expenditure, a part of which has to be financed through borrowings, implying that government fiscal management is unsustainable

Apparently in the wake of exorbitant oil price and spike in commodity price the government has undertaken an expenditure outlay, 30% of which is to be financed through borrowings – internal and external. Of the huge deficit (Tk30,580 crore), the bulk is expecting to be financed through domestic borrowing –bank borrowing and selling government bonds, reflecting that the blurring of divide between the fiscal and monetary authorities. Thus, government through its fiscal measures has imposed constraints on central bank to finance the deficit with creating demand for government bonds and with seignorage, which means that central bank has to create extra money for financing the government budget. As a result, the later would be less powerful to control over targeting inflation at the desired level.

Table – 2: Deficit financing

Description	Budget2008-2009	Percentage from the revised budget 2007-2008	Percentage change from the budget 2007-2008	Revised budget 2007-2008	Budget 2007-2008	Percentage change of the revised budget from the budget 2007-08
Foreign Borrowing	7236	-17.36	14.76	8756	6305	38.87
Domestic Borrowing	16998	-14.68	-11.82	19923	19276	12.72
Borrowing from Banking source	13498	29.81	86.10	10398	7253	33.79
Non-banking Borrowing	3500	74.83	-22.22	2002	4500	54.46

Output contraction

The proposed measures, entailing increased non-development expenditure and decreased development expenditure, would stimulate consumption expenditure and dampen down the productive expenditure. It is apparent that increase in consumption

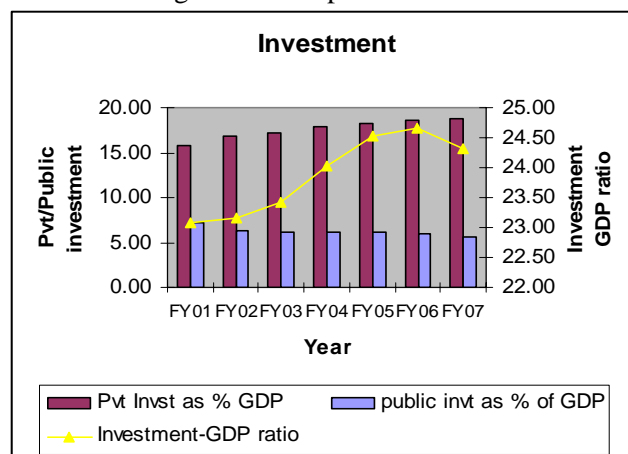
expenditure would lead to increase in aggregate demand of the economy whereas it is likely that private sector investment would shy away as a result of downward nature public investment, implying that the upcoming fiscal likely to see a short fall in aggregate supply. So it is more likely that there would be **an output gap**.

This could be also explained by the macroeconomic targets that have been set for the current fiscal. The growth is set at 6.5% for the fiscal 2008-09 as against 6.21% (expected) of the current fiscal (It is important to note that the growth has been set at 7% for the fiscal 2007-08). This clearly indicates about government's shyness about its development plan. A mere 0.3 percentage point increase in aggregate output in fiscal 2008-09 compared to fiscal 2007-08 would hardly be sufficient enough to increasing aggregate demand as a result of increase in aggregate consumption spending. It is apparent that such a low set of growth target would unlikely to meet the aggregate demand. So there would be an observable output gap in the upcoming fiscal. This also reflects the incoherence in the policy-mix of the government.

It is more obvious from the speech of the finance adviser when he spells out that there is nothing to be worried about in cutting down the development expenditure as the non-development expenditure is large enough to stimulate aggregate demand. He is absolutely right that the current expenditure would increase aggregate demand. But he is also sceptical about how the additional aggregate demand would be supplied through. His set of output target does not reflect his presumption of increasing aggregate demand. He is, however, optimistic about proposed tariff structures that he presumed would encourage investment.

Crowding out investment

When investment – public and private – is on downward trend the cut in planned development spending is expected to further shy the investment climate of the country, potentially leaving a long term negative impact. The finance adviser argued that the government would concentrate on implementation of the ADP instead of setting an ambitious development target. It is true for the government to admit the mistakes of the past year’s budget in which the ADP has been set ambitiously whereas the implementation level is dismal, yet the curtailment was not because of implementation capacity but due to the fact that government is already over burdened with the huge current expenditure that needed to be financed.



Since the development expenditure is a predetermined path of the long run economic growth it is imperative that public investment should be expedite in tandem while ensuring the effectiveness of the implementation capacity as the total investment scenario of the country has been wobbled given the economic and political outcomes of the country during the last few years. In general, increase in public investment stimulates private investment. Therefore, if there is a decline in public investment, the apprehension is that private investment would slow down and thus have a negative impact on growth.

It would have been wise to limit the current expenditure through streamlining of the ministries so as to increase the public investment with due attention of the implementing efficiency.

The proposed budget has redesigned the tariff structure replacing the exiting three tiers into four tiers facilitating the import of capital machineries, raw materials and intermediate goods. Also the proposed budget has given some tax and VAT incentives to SME ,cottage and agro-based industries, introducing zonal tax system for the industries, increasing the tenure tax holiday period and introduction of tax holiday system. This would indeed help local industries to grow and would encourage new investment.

However, concern is that unless there is a viable macroeconomic condition, mere incentive in tariff structure would help little to encourage investment. Clearly a large chunk of fund i.e. around 51% of the total budget deficit would be financed through domestic sources. As a result there is a likely effect of crowding out of private investment in one hand and monetary authority would remain under pressure to strike a balance between the inflation and interest rate and therefore money supply on the other. It means that high deficit financing tends to increase inflation that put constraints on central bank to contain money supply through increase interest rate, which would discourage private investment. Therefore when the finance adviser was boasts about his fiscal measures that he believes to encourage private investment he perhaps does not take into account the macroeconomic consequences that is imminent because of his overly indulged current expenditure measures that needed to be financed through borrowings.

Inflationary Pressure

The proposed measures are set to increase the current expenditure, which is mainly increased consumption expenditure. One of the main reasons to increase the current expenditure is the additional money required to subsidize oil and food, prices of which rose exorbitantly in the international market. Other reasons are increased salary of government staffs and widening of social safety-nets. The increased current expenditure is mainly non-productive expenditure and would encourage consumption spending, leading to increased aggregate demand. So there would be a tendency to unleash demand pull inflation as a result of increased non-development expenditure.

Table – 3: Some major areas of non-development expenditure

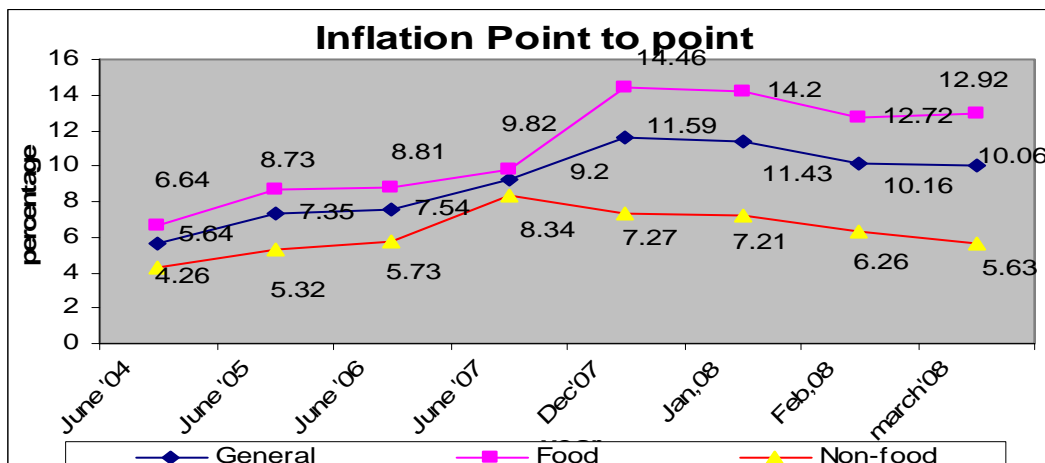
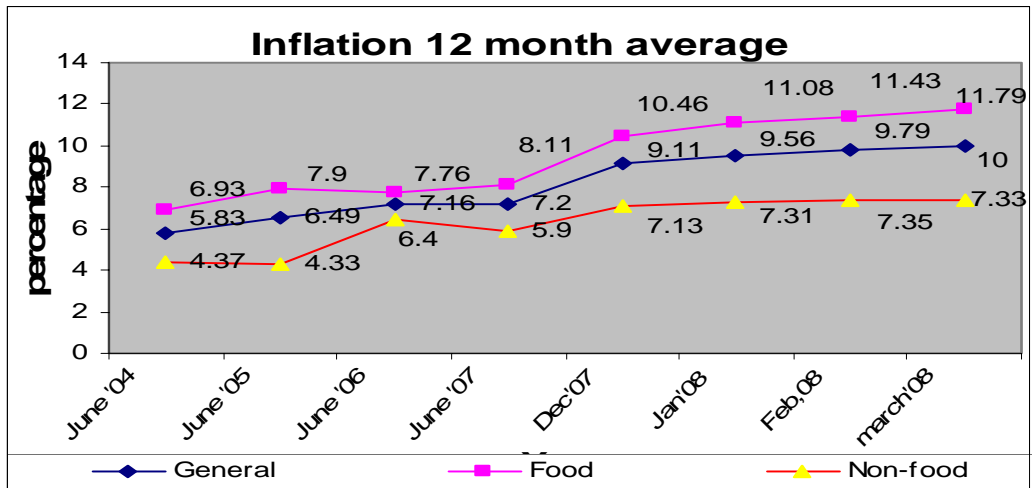
(Tk in Crore)

	Allocation	% of GDP	% of Total Budget
Non Development Expenditure	66753		66.75
Social Safety-Net Programmes	16,932	2.8	16.93
Agriculture Subsidy, Food Subsidy and Fuel Subsidy	13,648	2.2	13.65
Salary expanses of teachers and doctors	10,253	1.7	10.26

Justifying the increasing non-development expenditure and the reason to cut down development expenditure, the finance adviser spelled out that the dichotomy of the development and non-development budget is an artificial one. However, this expenditure is not to be incurred for any direct productive purposes but can be regarded as consumption expenditure, which would trigger the aggregate demand, translating into inflationary pressures.

Inflation remains worrisome as it is set to stay, even according to finance adviser, at 9% in the upcoming fiscal, implying that, macroeconomic stability would remain under threat in one hand, and the consumers would get little respite from the brunt of on-going inflationary trend,

on the other. Though the part of this high inflationary trend could be attributed to oil and food price-hike in the international market and its concomitant impact in the domestic market, the huge budget deficit, resulting in high government borrowing from the internal and external sources, have a consequential impact on the inflation. Moreover, the substantial portion of the government borrowing required to finance the consumption spending would also trigger inflation.



Besides the pressure on foreign exchange reserves would remain due to high import bills resulting from on-going oil and food price hike as well as constant pressure on repayment of the foreign borrowing. Therefore it would be difficult for monetary authority to undertake an investment friendly monetary policy as there would always be an upward pressure on interest rate, making the investment costlier, and additionally impacting on inflation. Furthermore, a current account deficit, if any, would lead the currency depreciation and this might push up inflation.

Caught in a debt trap

The current fiscal is already run down with high public borrowing, especially, that from the domestic sources. In this backdrop an even higher budget deficit would clearly worsen the public debt situation. In fact, there are concerns that the country is effectively caught in a 'debt trap' whereby a high existing level of outstanding debt implies a high level of interest payments which lead to a large budget deficit in the subsequent years that are to be correspondingly financed by large borrowings which add to the debt and so on. The result is increasing growth in debt and budget deficits which create fundamental macro economic imbalances and has a number of unfavourable consequences including the 'crowding out' of the private sector and a decline in

private investment through rise in interest rates and/or a rise in the current account deficit in the balance of payments.

The apprehension is that economy might trap into a double deficit – budget deficit and current account deficit - if the fiscal and monetary imbalances lead to an external imbalance through creating pressure on the exchange rate, which is more likely.

II. REVENUE ARITHMETIC

The proposed budget set the revenue target at Tk69328 crore for the fiscal 2008-09, up by 14.6% of the revised budget of the fiscal 2007-08. The revised budget set the target at Tk60539 crore, which is 11.3% of the total GDP, as against Tk57301 crore. The increased revenue earning is mainly due to some policy reforms in tax structure including identification of large taxpayers, opportunities given for declaring undisclosed income, special drive for collection of income tax and so on.

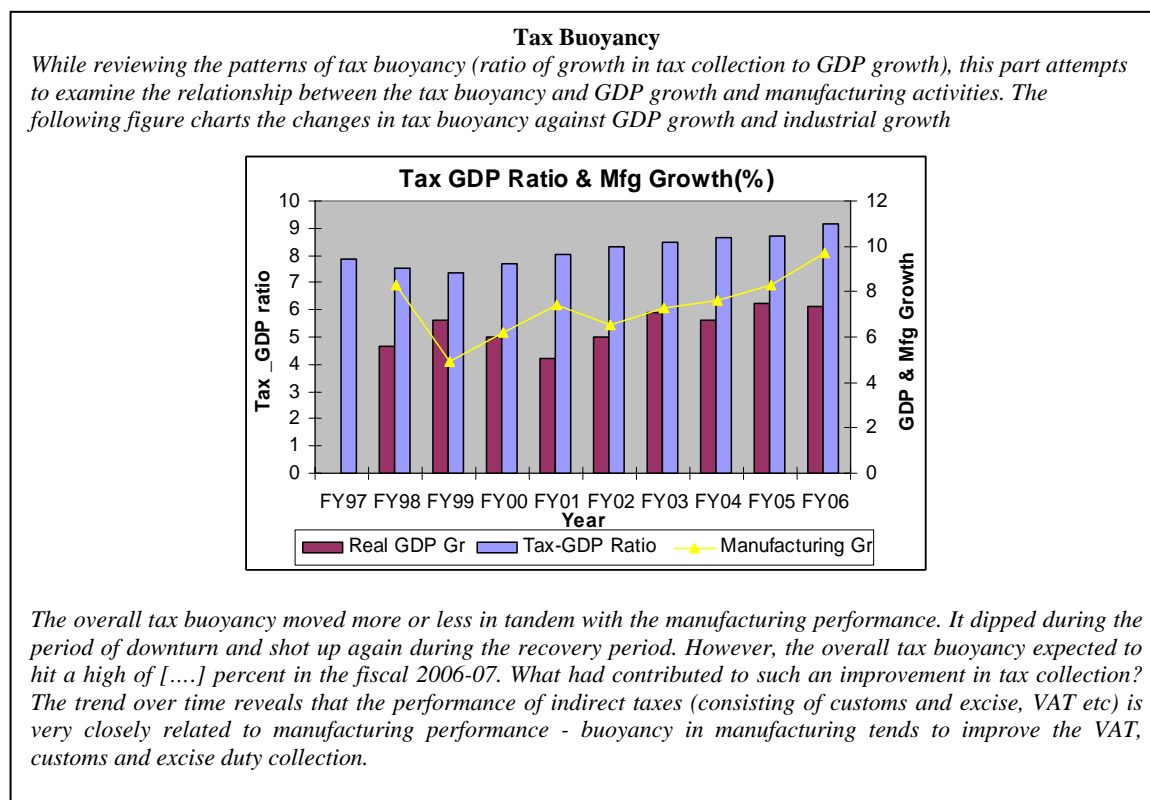
It is expected that the revenue target set for the current fiscal would be achieved if the on going reform in revenue department continues.

Like past, the revenue buoyancy projected in 2008-09 relies heavily, as usual, on indirect tax especially on the performance of VAT. The budget assumes 14.6% growth in total revenue receipts in FY 2008-09 over the revised budget of the preceding fiscal year. Of the total revenue collection, 81.85% would come from the tax revenue and remaining 18.15% from the non-tax revenue. About 23% of the total tax revenue is expected to come from direct taxes - income and corporate taxes and the rest from indirect taxation like VAT, customs duty, supplementary duty and other taxes.

Table – 4: Growth and Share (%) of Government Revenue

Tax heads	% share 2008-2009	2007-2008 (revised)	2007-2008 (original)	% Growth 2008-2009/ 2007-2008
Gross revenue	100	100	100	-
Total tax revenue	81.85	79.30	80	3.22
Non-tax revenue	18.15	20.7	20	-12.32
Total Tax revenue	100	100	100	
VAT	35.66	35.43	34.66	0.65
Import Duty	19.13	19.37	20.4	-1.24
Taxes on income and corporate profit	23	22.92	23.64	0.35
Supplementary Duty	13.73	16.6	15.64	-17.28
Other taxes	.99	.98	.87	1.02

Distribution of tax revenues show that earning is more skewed to VAT as it constitutes 35.66% as the government further widened the VAT net. This is followed by the income tax and corporate tax, which accounts for 23%. As the government continues to follow the trade liberalization measures, the dependence on import duty has been reduced to 19.13% and supplementary duty to 13.73% of the total revenue.



It shows that there is a policy inconsistency in relation to the objective of growth with equity and government structure of revenue collections. This is because **the government's tax structure is regressive in nature.**

Indirect tax grows at a faster rate than direct tax, since former is more elastic to GDP than the later. The problem is that in case of indirect tax both rich and poor bear the same tax burden. Given the prevailing nature of income distribution in an inflationary economy the poor have been affected adversely as they pay more tax in proportion to their income compared to that of rich.

Social Safety-Net Programmes

Against the backdrop of food-inflation, government has introduced some new social safety net programmes to ease pressure on poor and lower and middle income groups. In this regard the allocation to social safety net programmes has been proposed to increase by 48% to Tk16,932 crore compared to the revised budget of the preceding fiscal. In addition newly initiated '100 days employment generation' programme would ensure employment opportunity to those who remained unemployed in lean season apart from that of existing 'Food for work' programme. It is estimated that more than 20 lakh unemployed people would be guaranteed to be employed under these programmes. Also in the next fiscal year allowances programme for widowed, deserted and destitute women are raised from Tk220 to Tk250 per person and the total allocated increase is of 9.0%. The pilot programme "allowance for poor lactating mothers" has been widened, increasing beneficiaries by 33.33% to 60,000.

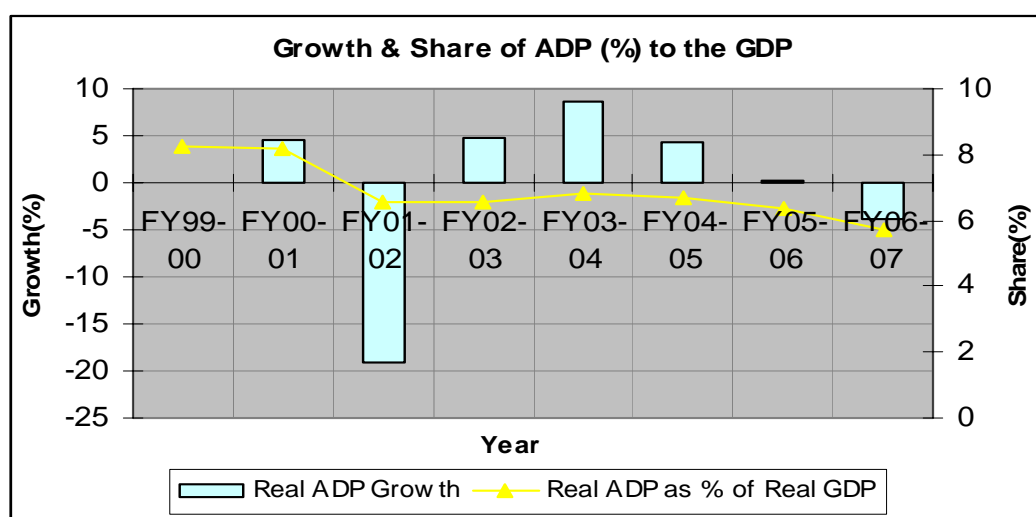
The concern is that excepting few, the most of the social safety-net programmes are on-going to feed poor and extreme poor, which so far have little contributed to fight against poverty. Given the poverty scenario of the country the social safety-net programmes are not sufficient to cover enough poor and marginalised. On the other hand proper implementation, distribution and delivery of these programmes remain questionable.

Climate Change and Disaster Management

As climate change has become a vital issue across the world and the recent floods and cyclone Sidr are inevitable results of the global climate change the budget proposes to create a Fund for Climate Change by allocating Tk 300 crore. What is missing in that allocation is financing of acquisition of low carbon technology to maintain the growth path with reduced carbon footprint.

Development Expenditure

While the objective of the government remains reduction in poverty through output expansion and employment generation, the public investment scenario remains poor. The government expenditure has increased significantly, the ADP for the fiscal year 2007-08 cut down massively to Tk22500 crore from Tk26, 500 crore and only 54% has been implemented till April, 2008.



This is mainly due to two reasons: firstly, among the many, one of the main conditions for the donors is that it often insists government to contain the budget deficit. Since the tax buoyancy remains problematic as tax-GDP ratio lying just above 11%, which is still far below from that of many of the neighbouring countries, the government is forced to resort to fiscal austerity measures. Thus the government has to compromise on development programmes, especially, those targeting poor, as there is hardly any scope to cut down the current expenditure. Secondly, implementation problem is a common phenomenon every year.

Implementation of the ADP would remain a challenge. First of all, the question remains whether the government would get enough funds for the investment, as it has to depend on domestic borrowing, foreign loans and grants. Secondly, the implementing agencies have to be efficient since a non-political government is less accountable than a political government.

Agriculture

The finance adviser has proposed to allocate Tk1050 crore for agriculture in the upcoming fiscal, up by 4.03% per cent from the preceding revised budget. The government has also

allocated Tk1650 crore as subsidy for fertilizer and agriculture subsidy. Subsidy for fertilizer, electricity and others Tk. 4285 has been allocated. In addition a special allocation of 122.96 crore will be spent for food security.

Nevertheless, given the numerous constraints faced by the agriculture sector, three questions still comes in the way: Firstly, does the allocated budget is sufficient to agriculture? Secondly, how much of the proposed outlay really going to be implemented? Thirdly, would the benefit go to the marginal farmers?

While the first question is to deal with two concerns, namely, the allocation in real terms (after adjusting inflation) and the latest government policy to further easing the food items, the past experiences are not pleasant as far as the last two questions are concerned. It is conspicuous from the past experiences that ADP is not satisfactory at the implementation level. For example, in the first ten months of the current fiscal, 61% of the ADP in agriculture has been implemented.

The amount of subsidy is very insufficient. Bangladesh is giving less than 1% subsidy of its agriculture output whereas neighbouring India is giving around 9% subsidy to its agriculture. Besides, the sub sector of agriculture is obscure. The concern of agricultural subsidy also rest upon the efficacy of its use as it is often claimed that subsidy does not reach the marginal farmers.

Physical Infrastructure

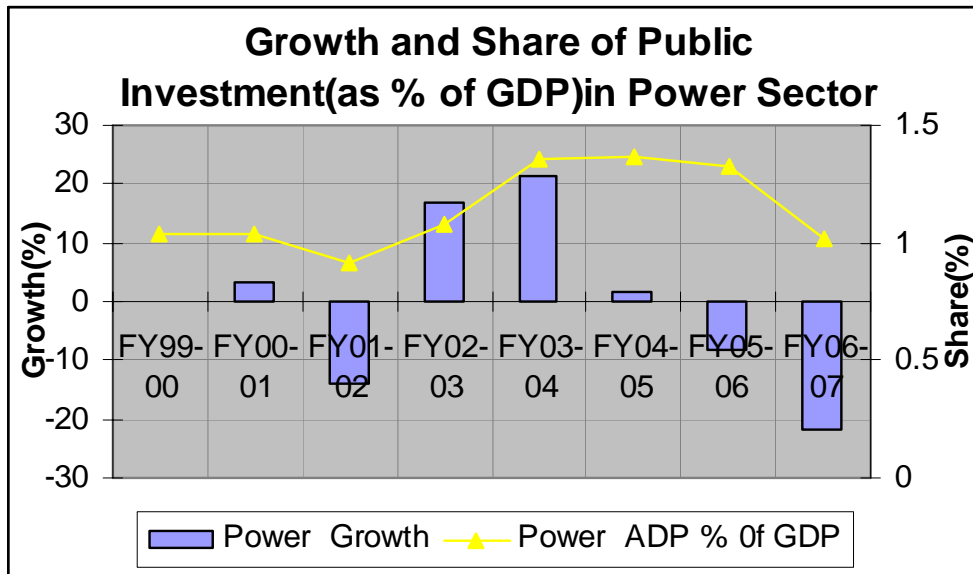
There is no denying the fact that an enabling environment is prerequisite to induce private investment. In this regard, the role of the state is to invest in order to ensure the availability of physical infrastructure. Unfortunately, the state of the public investment in physical infrastructure development remains poor over the past few years.

Though in nominal term there has been an increasing trend on investment in physical infrastructure development, in real term (after inflation adjustment) public spending has not increased enough, in many cases remained stagnant or even witnessed negative growth. As a result, the proportionate government expenditure (as a percentage of GDP) on physical infrastructure development has been declining.

As far as physical infrastructure is concerned, the main challenge for the government is to generate power supply for the years ahead.

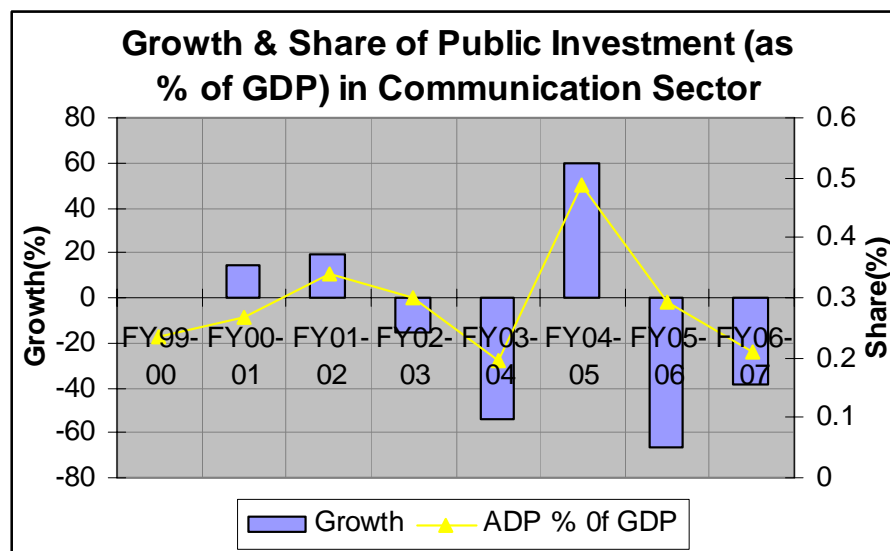
Bangladesh is one of the lowest per capita consumption of power and coverage of electrification among developing countries. In 2007 per capita electricity consumption stood 140MW (e.g. India: 665 kWh; Sri Lanka: 325 kWh and Pakistan: 408 kWh). Despite above facts country's power sector has remained neglected.

After a negative growth of government real investment on power sector (-2.67% in 2001 and -15.53% in 2002), it increased to 30.88% in fiscal 2003, which slowed down in the subsequent years and marked a negative growth of 21% in fiscal 2007. The share as a percentage of GDP (after inflation adjustment) has been hovering between 1% and 1.25% during the period under consideration.



Against this backdrop, the finance Adviser has announced the proposed development plan for power and mineral sector worth Tk4340 crore which is 21% higher than revised budget 2007-08. The government has planned to increase power generation over the next three years by 400MW by 2010.

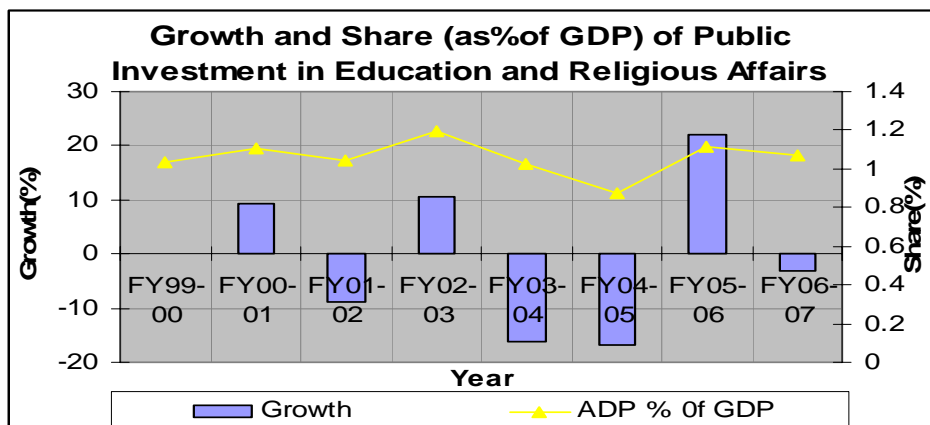
Growth of public investment (after inflation adjustment) in communication sector was fluctuating between 2000 and 2007. Over last two year real investment growth declined. The share as a percentage of GDP also witnessed a trend of rising 0.32% in 2002 from 0.20% in 2000, again plunged to 0.14% in 2004, followed by 0.48% in 2005, 0.30% in 2006 and 0.20% in 2007.



Education

As the GDP grew over 5% to 6% during the last few years, the proportionate public investment on Education has not increased in real terms till 2005. In 2006; it grew by 1.1% following a negative growth -3.2% in 2007.

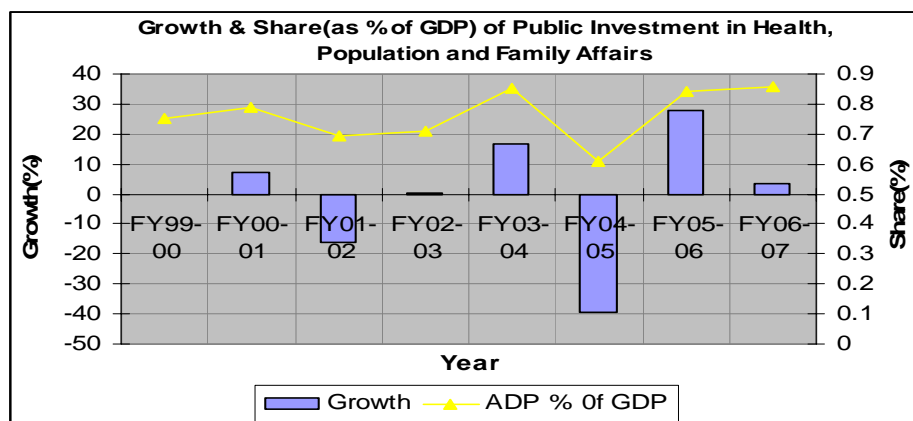
Though the budgetary allocation remains highest for the education sector, the public spending in real terms has declined over the years, reflecting the poor quality of education.



Health

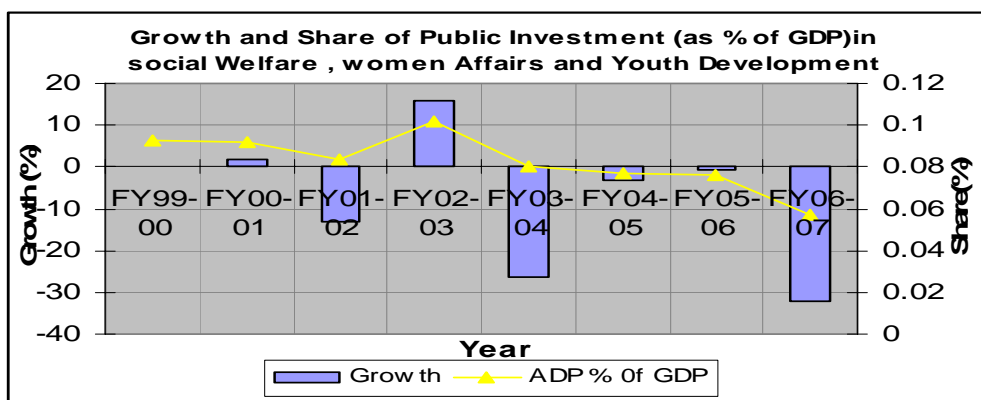
Public investment in Health and Population and Family Welfare sector has also marked negative growth (in real terms) during most of the period between fiscal 2000 and fiscal 2005 (-6.93% in 2001, -7.66% in 2002, -2.09% in 2003, 16.18% in 2004, -4.97% in 2005, 28.39% in 2006 and 3.2% in 2007). Its share in proportion to GDP (after inflation adjustment) declined from 0.71% in fiscal 2000 to 0.60% in fiscal 2005, before raising it to 0.85%.

The negligence of the public investment reflects the poor quality of the public health system across the country, both in urban and rural areas.



Social Welfare, Women Affairs and Youth Development

The expansion of public investment in social welfare, women affairs and youth development remain dismal. The government spending in real terms was negative which is, -28.68 in 2004, -3.29% in 2005, -0.63% in 2006 and -31.95% in 2007. The investment in proportion to GDP remains at negligible level, slid to 0.057% in 2006 from 0.073% in fiscal 2000.



III. CONCLUSIONS

Like the previous budget, the finance adviser has fallen short to bring together the traditional three-pronged role of fiscal management: stabilization, allocation, and distribution, all of which can be conducive to growth. The tax and subsidy system which embody the fiscal instruments have not been carefully put in place to steer parallel processes of *resource generation* (growth) and *distribution* for capability enhancement and containment of deprivation and social protection (distributive justice).

In conclusion the central to our argument is not only to look at the short term crisis but to bridge the short term economic management with long term objectives. It is apparent that fiscal imbalances would create monetary imbalances may result in monetary imbalances. This is clearly the reflection of lacking coherence between the macro rules, expenditure rules and budgeting process implying that long term macro economic goals are not being reflected in the decision making process. Moreover, slowing down of investment – both public and private – as a percentage of GDP that has been perceived since fiscal 2006-07 is another cause of concern, indicating that growth path likely to see instability in near future with increasing unemployment and inflation.

Last but not the list the central to our argument is that the criteria for economic policy formulation are necessarily related to the political institutions of the society. Therefore the budgetary process needed to be implemented by the political institutions under a democratic regime without which the social welfare maximization would not be achieved.