

# Meeting the Challenges of Macroeconomic Stability and Growth

**Recommendations for the  
National Budget 2007/2008**



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# Contents

	Page
<b>Executive Summary</b> .....	ii
<b>1. Introduction</b> .....	1
<b>2. Major developments in FY07 and key challenges</b> .....	2
Economic growth, savings and investment.....	2
Fiscal management.....	3
Monetary developments and inflation .....	5
External sector developments .....	9
Major sectoral developments.....	10
Recent status of MDG indicators.....	12
Critical areas requiring attention in FY08 budget.....	13
<b>3. Recommendations for the national budget FY08</b> .....	14
<b>3.1 Re-setting investment priorities for sustaining growth momentum</b> .....	14
<b>3.2 Management of inflation</b> .....	15
<b>3.3 Resource mobilization</b> .....	16
Enlarging the tax base.....	16
Tax holiday system.....	17
Zero import duty .....	18
Non-tax revenue.....	19
Efficiency of tax administration.....	19
Capital market development.....	19
<b>3.4 ODA inflows</b> .....	21
<b>3.5 Size and quality of public expenditure</b> .....	22
<b>3.6 Sustaining export growth</b> .....	23
<b>3.7 Support to agriculture and the rural economy</b> .....	24
<b>3.8 Human resource development: quality and equity issues</b> .....	25
<b>3.9 Social protection issues</b> .....	27
<b>4. Concluding remarks</b> .....	28
<b>Annex 1: Current status of selected MDG indicators and future imperatives</b>	30
<b>Annex 2: Estimates of revenue loss from tariff reduction in selected     food imports ...</b>	36

## ***Executive Summary***

### **1. Introduction**

1. The fiscal year 2006/07 (FY07) witnessed unprecedented political turmoil, culminating in the promulgation of emergency along with the formation of a new interim government to run the country. These political developments and the heightened political, social and economic uncertainties had significant bearing on the performance of the economy, especially prior to the installation of the interim government in January 2007.
2. In view of these developments, the FY08 budget needs to focus on three priority tasks: (i) restoring normalcy in different spheres of economic and social life; (ii) undertaking effective measures against major adversities currently faced by the economy (such as, rising trend in prices of essential commodities, power shortage and 'fertilizer crisis'); and (iii) initiate long-term measures and actions that would pave the way towards high economic growth and rapid social development as envisaged under the MDGs within the PRSP framework.
3. Although the present interim government has a somewhat limited mandate and would focus more on short-term, urgent, and key concerns facing the economy, the FY08 budget should also take the opportunity of taking 'hard economic decisions' on some key strategic issues that have been plaguing the economy for a long time but the earlier governments were unwilling to act due to the existence of strong pressure groups and/or other political reasons.

### **2. Major developments in FY07 and key challenges**

4. So far, FY07 has been marked by some contrasting developments having both positive and negative implications. The present assessment uses, in most cases, six-monthly data (until December 2006) and projections based on current trends, assuming prevalence of normal conditions during the rest of the fiscal year.
5. The real sectors of the economy seem to have performed relatively well and the GDP is expected to grow by 6.5% during FY07 as against 6.7% achieved during FY06. The growth in agriculture is likely to be lower (estimated at around 2.8%) than last year's high growth of 4.5% partly due to lower production of rice and partly due to the fact that high agricultural growth in FY05 showed recovery over previous year's flood damages. The industry sector is likely to grow at around 9.5% despite the labour unrest that affected the export-oriented RMG sector during the year. The services sector is expected to follow its trend growth which was 6.5% in FY06. The challenge of sustaining high growth rate, however, is increasingly facing the odds of deficient infrastructure, including power, port, and transport, affecting a wide spectrum of economic activities across rural and urban areas.
6. Domestic savings was 20.3% of GDP in FY06 and, given the overall economic situation, it is not likely to change much in FY07. However, national savings (which was 26.6% in FY06) is expected to increase during the current fiscal year due to higher inflow of remittances. With a largely stagnating gross investment-GDP ratio over the last five years, it is unlikely to change much in FY07 from the level of 25% in FY06.

7. The target for revenue receipt for FY07 was set at Tk. 525.42 billion (11.3% of GDP) which was 17% higher than the revised estimate for FY06. During the first eight months (July 2006-February 2007) of FY07, taxes collected under NBR were Tk.216.52 billion (higher by 9.2% over the same period of the previous fiscal year) but lower by Tk. 57.2 billion of the target during the period. Both slow revenue collection and low aid disbursement adversely affected the projections of proposed financing of the budget deficit. During the first five months (July-November) of FY07, the budget deficit was almost fully met by domestic financing, with only 2.3% contributed by foreign financing. Net aid disbursement declined by 89% compared with the same period of FY06. During the period, government borrowing from the banking sources increased by 32% and from nonbanking sources by 110% indicating that, unless these trends are not restrained, the government is more likely to overshoot the borrowing targets in FY07.
8. The total size of FY07 budget was set at Tk. 697.40 billion (15% of GDP). The size of ADP was Tk. 260 billion, which was 21% higher than the revised ADP of FY06. The actual expenditure of ADP was only 80% and 85% of planned allocations during FY06 and FY05 respectively. The implementation status of the current year's ADP has been very slow, with only about 25% of the funds utilized during the first six months of FY07. Given the present implementation capacity of public sector agencies as well as resource and other constraints, a realistic size of the revised ADP for FY07 may be set at around Tk. 220 billion.
9. Despite attempts to pursue a restrained monetary policy, money supply continued its sharp growth in FY07 mainly due to rapid expansion of domestic credit. The annual growth rate of broad money (M2) was recorded at 22.3% in December 2006 compared with 17.2% in December 2005. Private sector credit growth increased to 19.4% and net credit growth to the government increased to 35.9% in December 2006 compared with 18.3% and 27.0% respectively in FY06.
10. The point to point inflation rate increased from 6.8% in July to 7.3% in October 2006. A slight decline to 6.1% is reported in December 2006. The target is to contain annual average inflation to 7% in FY07 compared with 7.2% in FY06. At present, inflationary trend persists in the economy and containing inflation at the projected level would require actions on both demand and supply sides, including moderating the upward fluctuations in food prices, softening of nonfood prices through ensuring smooth supply and optimal inventory accumulation, pursuit of cautious monetary policy, and socio-political and financial stability.
11. So far, developments in the external sector have been encouraging. The export target for FY07 has been set at US\$ 12.5 billion. During the first seven months (July 06 to January 07), total export earning is estimated at US\$ 7039.7 million (about 4.5% lower than the target for the period) but higher by nearly 21.4% of the actual export earnings during the same period of FY06. The growth targets for items like woven wear, frozen food, engineering products, processed food and leather products were exceeded but exports of knitwear, leather and raw jute fell short of their targets.
12. Total imports during FY06 amounted to US\$ 14.8 billion indicating a growth rate of 12.2% over the previous fiscal year. Imports grew by 20.7% during July-November 2006 compared with 10.9% during the corresponding period of 2005. The trade deficit during July-November 2006 increased to US\$1,165 million from US\$ 1,132 million over the same period of 2005 due to higher absolute size of imports. The current account recorded a surplus of US\$302 million mainly due to the surge in remittances. Remittances amounted to US\$ 4.8 billion in FY06,

which was 25% higher than the level of FY05. During July-January of FY07, remittances grew at a healthy rate of 29%. The overall balance during the first five months of FY07 showed a surplus of US\$ 157 million from a deficit of US\$ 463 million during the same period of FY06. Foreign exchange reserves rose to more than US\$ 4 billion at the end of December 2006.

13. The gross disbursement of foreign aid during FY06 was US\$ 1,241 million (less by 1.5% of the amount during FY05) while the net foreign aid inflow was US\$ 752 million, which was 7.3% lower than the corresponding figure of FY05. The disbursement of foreign aid in FY07 is also likely to follow the declining trend, which has already created a severe pressure on the domestic sources of borrowing. For major macroeconomic aggregates, a summary of the MTMF targets as given in the PRSP and actual performance for FY06 has been given in Table 1 in the text. For FY07, since the data on actual performance cannot be given at this time, the budget value is given and the likely achievement of the targets is indicated based on the current trends.
14. The progress achieved so far in terms of major MDG indicators is given at Annex 1. In general, the table shows that Bangladesh has made significant progress in several areas of human and social development and is “on track” to achieve the MDG targets for many of the indicators. However, there also exist several areas of concern, particularly in important sectors like health, education, gender equality, and in ensuring environmentally sustainable growth. The last mentioned issue has become critical because of the fast eroding natural resource base as well as its severe degradation.
15. Bangladesh has a long way to go even if the MDGs are achieved. For example, even if we are able to halve the population who live in poverty by 2015 (MDG1), still nearly 47 million people would remain poor and more than 22 million would be living in extreme poverty in 2015. It is also important to realize that future progress towards achieving the MDGs would require maintaining the present trend and, in certain cases, increasing the current rate of progress. For this, increasingly more efforts and resources would have to be devoted to achieve the same level of success as the easier options are exhausted and the compulsion would be to address the harder cases.
16. The review brings out nine areas that need special attention in FY08 budget. These are summarized below:
  - **Re-setting investment priorities for sustaining growth momentum:** Macroeconomic fundamentals; productivity growth in agriculture; major bottlenecks in infrastructure; improvement in investment climate.
  - **Management of inflation:** Both demand-pull and cost-push dimensions of inflation; inflation-related trade policy issues; institutional measures to ensure reasonable prices of essential commodities.
  - **Resource mobilization:** Measures to broaden the tax base and increase the efficiency of tax administration; tax rationalization; measures to increase non-tax revenues, capital market development.
  - **ODA inflows:** Reverse the declining trend in net ODA inflows; PRGF and DSC support.
  - **Size and quality of public expenditure:** Rolling investment programmes and MTBF; ADP size and project quality; sectoral allocations.
  - **Sustaining export growth:** Export growth and export diversification.

- **Support to agriculture and the rural economy:** Areas of support, adequate and timely supply of fertilizer, diesel and other inputs; demand and supply side bottlenecks of rural non-farm enterprises and SMEs.
- **Human resource development-quality and equity issues:** Adequate, affordable, and equitable access to quality education and healthcare services.
- **Social protection issues:** Strengthening existing programmes; new programmes for hardcore and vulnerable poor and displaced persons.

### 3. Recommendations for the national budget FY08

17. The recommendations are summarized below while the contexts and the rationales are explained in the text.

18. Recommendations on sustaining growth momentum and re-setting investment priorities:

**Macroeconomic stability:** The recommendations are given under specific heads in different areas.

**Manufacturing sector:** (i) Minimize power supply constraints and the frequency of power outages; (ii) vigorously promote Bangladesh's ability to attract FDI in manufacturing;; (iii) initiate measures to improving access to quality tertiary (especially technical) education to address human capital deficiencies; (iv) implement a well-thought out sequence of trade liberalization measures; (v) ensure adequate flow of credit to manufacturing activities.

**Power sector:** The power sector is in the midst of a long-term crisis. Development of the sector should receive a high priority with adequate allocations in FY08 budget along with measures to attract foreign and/or private investment. (i) Undertake measures to urgently make available "the captive power" existing in different establishments to the national grid; (ii) Rehabilitate the currently closed small but viable power generating units on an urgent basis to augment short-term power supply; (iii) Use load management in a judicious manner to minimize the losses to the production sectors of the economy; (iv) Undertake a scrutiny of all proposals of new power generation projects and provide quick approval to viable projects (both short and long-term ones) following rules and regulations in a transparent manner; (v) Initiate actions to import electricity from neighbouring countries (e.g. Bhutan and Nepal); (vi) Energy pricing is a vastly complicated issue which has been widely politicized. The government needs to come forward to institutionalize a "formula approach" to determining domestic fuel prices linked with world market prices and other considerations; (v) Address critical governance issues in the power sector, particularly those relating to the power purchase agreements which need to be reviewed. The present "cost plus" system needs to be changed to a "price cap" or "yard-stick" pricing to prevent fraudulent activities.

**Transport and port sector:** (i) Implement policy and institutional reforms at Chittagong and all other sea and land ports; (ii) Implement complementary trade facilitation measures including increasing custom bonded facilities and developing inter-connection transport infrastructure; (iii) Undertake measures to modernize the railway system (with support from development partners) and initiate the construction of Dhaka-Chittagong expressway with foreign collaboration; (iv) Implement the Jamuna bridge link project.

**Services sector:** (i) Provide incentives for developing private industrial estates; (ii) Modify the SME refinance project of the Bangladesh Bank such that credit funds do not disproportionately flow to trading activities; (iii) Open special window for "women entrepreneurs" for SMEs in all banks; (iv) Expedite the implementation of the ongoing financial sector reform programme including restructuring of the NCBs; (iv) Develop objective criteria for bank licensing, subject all banks to regular audits to ensure long-term viability, and review and reform the legal framework for bank failure resolution; (v) Strengthen regulatory and supervisory frameworks for capital and insurance markets; (vi) Expedite the scrutiny of applications by the SEC so that new IPOs can be floated quickly.

19. Recommendations on management of inflation:

**Supply augmentation:** (i) Adopt some short-term measures to augment the supply of essential consumption goods and critical inputs through reducing custom duty, supplementary duty and other surcharges;

**Price adjustment:** (i) Any increase in oil prices, especially of diesel and kerosene oil, should be done gradually to avoid any major shock to the productive sectors of the economy and the poorer groups;

**Administrative and other measures:** (i) Adopt effective administrative measures to liquidate any syndication of the import trade that may exist, bring a competitive environment in import trade, and prevent large-scale smuggling of imported commodities like diesel, kerosene oil, edible oil and fertilizer; (ii) Encourage small importers (if necessary by forming groups) to participate in import activities for which the banks may provide incentives such as through reducing L/C margin and providing easy access to other financial services; (iii) Ensure fiscal discipline as a complement to tight monetary policy in curbing inflation; (iv) Undertake effective measures through the trade bodies and other channels to ensure the genuine importers that there will be no barrier and harassment for law abiding business; (v) Form an independent *Commission on Market Surveillance of Essential Commodities* with representatives from relevant government ministries, importers, trade bodies, consumers and other concerned stakeholders to monitor market situation including prices, stocks, domestic availability, pipeline imports, demand forecasts and other indicators to regularly produce and publish advanced quarterly reports so that appropriate actions can be initiated to avoid any market instability; (vi) Reorganize the Trading Corporation of Bangladesh (TCB) into an autonomous commercial organization to regularly engage in imports of essential commodities so that it can retain some market power to avoid any unforeseen fluctuations in supply and availability of essential imported commodities; (vii) Undertake measures to promote efficient market institutions including rules and regulations so that the presently ruptured “market and import chains” can be mended rapidly through effective measures such as regaining confidence of traders by stopping unnecessary anti-hoarding drives (maintaining normal level of stocks and speculation are regular business activities in a market economy), remove any entry barriers that may exist in import trade to bring competition and remove the existence of so-called ‘syndicates’, restructure and strengthen BSTI to ensure quality and non-adulteration and undertake other confidence building measures for doing fair business. A “crack down” approach is not a viable alternative to solving the ills of the economy; rather the need is to follow a systematic institution building process.

20. Recommendations on increased revenue mobilization:

**1. Personal income tax:**

**Expanding the tax base:** (i) Conduct administrative drives (in areas where potential taxpayers are likely to be high and current coverage is low) to expand the tax base, further simplify tax return procedures, improve administrative efficiency and conduct surveys to identify potential taxpayers; (ii) Make it compulsory to quote/present TIN for holding credit cards, membership of clubs, admission of children in expensive private institutions like kindergartens and universities, membership in professional organizations and similar other places; (iii) Further enhance the scope and coverage of the Large Taxpayers’ Unit.

**Tax assessment:** (i) Abolish the provision of regularizing “black money” through paying a nominal tax; (ii) Implement a built-in system of strong deterrence and punishment against willful tax evaders and non-compliers; (iii) Review the existing personal income tax rate and restructure it to be more progressive.

**2. Corporate income tax:**

**Exemptions and allowances:** (i) Abolish all exemptions and allowances and/or minimize in special cases; (ii) Discontinue the tax holiday facility and replace it by either ADA or a uniform reduced tax rate; (iii) Abolish the exemptions of tax in respect of capital gains and, in deserving cases, these may be taxed at preferential rates; (iv) Extend the purview of the highest corporate tax slab (45%) applicable in the cases of banks and insurance companies to include other profit making service industries such as in the telecommunication sector; (v) Implement a time-bound plan to ensure that all units of the corporate sector implement harmonized and international accounting standards as adopted by the ICAB to ensure proper tapping of the corporate profit tax; (vi) Rationalize the structure of corporate tax in line with those of neighboring countries in view of the free trade arrangements under SAFTA.

**3. Customs duty:**

**Rationalization:** (i) Abolish zero rate of duty except in cases where international treaty or obligations exist or strong humanitarian reasons prevail; (ii) Eliminate all concessionary rates and, if any duty concession is given under special circumstances, it should be approved by the Parliament before or within three months; (iii) Eliminate all dispersions of duty rates within 4-digit tariff heads; (iv) Discontinue the practice of making mid-term changes of duty through SRO except in special cases like natural disasters and other emergencies; (v) Enhance supplementary duty on vehicles for personal use and other items generally used by the richer segment in society; (vi) Overhaul the PSI services to remove existing loopholes.

**Procedural reforms:** (i) Reform the customs clearance process to make it more efficient and less time-consuming following recommendations (Appendix II) of Revenue Commission Report 2003; (ii) Discontinue the diplomatic bonded warehouses; (iii) Conduct a review of duty

drawback, rates and coefficients and revise accordingly; (iv). Regularly review and frame adequate rules of imposing safeguard duty to combat unfair international trade.

**4. Value added tax (VAT):**

**Expansion of VAT net:** (i) Progressively expand the VAT net every year to cover all potential products and services including secondary agricultural products.

**Registration and collection:** (i) Streamline the registration system at division office level; (ii) Streamline existing VAT rules and orders and simplify the forms and procedures; (iii) Undertake measures to introduce VAT inclusive MRP for all products; (iv) Use VAT stamps of different denominations for 'hard-to-tax' areas; (v) Collect turnover tax from larger SMEs.

**5. Other taxes:**

**Local level taxes:** (i) Local level taxes are yet to be a major source of revenue while subventions to local governments are a major drain on the national exchequer. Remedying these would necessitate several institutional and policy changes. While the government may look up the Report of the Local Finance Commission set up in the mid-1990s, there is a scope for rationalizing the Immovable property tax as well as the urban land development tax. The latter, particularly should be imposed at a high rate so that land does not remain unutilized and unproductive for long. (iii) Impose location-specific higher and differential tax rates for land used for residential and commercial purposes in large cities (e.g. Dhaka, Chittagong and other city corporations) and apply the same principle in other cities and upazila headquarters.

**Land development tax:** (i) Make upward revision of the tax rate; (ii) Bring large agricultural landowners under the tax net; (iii) Impose location-specific higher and differential tax rates for land used for residential and commercial purposes in large cities (e.g. Dhaka, Chittagong and other city corporations) and apply the same principle in other cities and upazila headquarters.

**6. Non-tax revenue:**

**Land registration:** (i) Abolish all discretionary power of Sub-Registrars and simplify registration procedure; (ii) Rationalize land valuation by increasing existing rates to reflect market prices in different locations; (iii) Rationalize the minimum value of flats and buildings for tax purposes reflecting current market prices and locational variations .

**7. Licensing of TV, radio and motor vehicles:** (i) Collect a one time license fee at prescribed rates during purchase. The seller will be responsible for the collection of the fee and appropriate administrative arrangements should be designed for implementation; (ii) Review the current structure of registration fee for motor vehicles and work out a schedule that introduces very high fees for high-capacity and expensive cars for personal use.

**8. Tapping special funds:** (i) Access special funds for specific development interventions (e.g. in the energy sector) under international protocols. Under the Kyoto protocol of the UNFCCC, the government may access funds under the instrument of Clean Development Mechanism applicable for developing countries (including the LDCs) for setting up power plants using natural gas, rehabilitation of industrial boilers serving as a source of substantial energy loss and deforestation.

**9. Capital market development:** (i) Simplify the tax filing procedures e.g. treat the 10% tax at source on dividend income as final settlement (similar to tax at source on interest income from bank deposits); (ii) Review the existing provision of corporate tax for listed and non-listed companies. The tax differential between these two types of companies may be increased from 30% and 40% to say, 30% for listed and 45% for non-listed companies to put pressure on non-listed companies to become listed; and set a minimum limit (e.g.25% excluding pre-IPOs, institutional placements, and the quota for mutual funds) for off-loading shares to the public for consideration as a listed company; (iii) Place a time frame for the currently listed companies to off load at least 25% (or more) of their shares to the public for being treated as a listed company for tax purposes. Similarly, put a limit on holding the maximum number of shares of a company by its sponsors in order to be considered as a listed company for lower tax purposes; (iii) A limit could be placed on the extent to which a company can charge a premium on its IPO as well as on the issue of right shares in the public interest; (iv) Divest the shares of profitable SOEs to increase the supply of good shares in the stock markets.

21. Recommendations on ODA inflows:

**Increase ODA inflows:** (i) Take initiatives to release, as much as possible, the project aid stuck in the ever-growing pipeline; (ii) Give priority to address the problems of management and implementation capacity of the aid-financed projects, resolve procurement issues, and ensure timely approval of projects and regular provision of matching domestic resources; (iii) Improve the quality of government-donor relationship and its effectiveness to address the issue of poorly-designed projects and provide support to the priorities in the PRSP agenda; (iv) Undertake effective steps to improve the access to budgetary support especially through IMF support under the PRGF together with the Development Support Credit which are contingent upon fulfilling several targets in specific areas and other conditionalities. A review of these conditionalities may be undertaken under the changed circumstances and mutually agreed upon ones may be re-set.

22. Recommendations on size and quality of public expenditure:

**Size of public expenditure:** (i) Make a conservative and realistic estimate of the size of public expenditure with a minimum increase of non-development expenditure; (ii) Limit the size of FY08 ADP at a level of around Tk. 230 billion, which will be about 5% higher than FY07 revised ADP.

**Quality of public expenditure:** (i) Undertake a comprehensive exercise of review of all projects included in FY07 ADP and drop all projects of dubious quality using criteria suggested by the PERC; (ii) Limit the total number of projects included in FY08 ADP at a manageable level and include only approved projects in line with the budget and PRSP priority objectives and for which resources are available; (iii) Further streamline the procedure of selection of new projects (iv) Give priority to selection of projects for which external assistance is available through the pipeline and which fit with our priorities; (v) Direct more resources to on-going projects which have made the most progress so that the benefits can be realized within a short period; (vi) Give priority to projects in critical sectors like agriculture, power, and social sectors.

**New areas of public expenditure:** (i) Public expenditure along with support to community initiatives are necessary to provide people with safe drinking water and protect them from the adverse health impacts of heavily polluted physical environment. The monies may be used for developing necessary skills, increasing community resilience and technical interventions. Collaboration across the board among the Government, NGOs, communities and the private sector may be necessary for this.

23. Recommendations on sustaining export growth:

**Trade policy issues:** (i) Further rationalize import tariff on raw materials and extend bonded warehouse facility, in selected cases, for potential export industries like pharmaceuticals, plastic and melamine products, and processed food products; (ii) Take effective measures to diversify the export basket such as through providing budgetary support to promote potential export industries like the ICT sector; (iii) Encourage assembling industries through tariff incentives on CKD and SKD components in a time bound manner to lead to full fledged local production activities; (iv) Set up central bonded warehouse for the RMG sector with adequate safeguards against pilferage to reduce lead time in the post-MFA competitive environment; (v) Take special measures (e.g. fiscal incentives) to attract European investment as joint venture in potential export industries to diversify export basket to EU under EBA facility; (vi) Strengthen the capacity of the BSTI in general and more specifically for testing the quality of products under SPS provisions of WTO and harmonize national standards with both regional and global standards (both Codex and EU-specific).

**Remittances:** (i) Streamline rules and procedures to stop the exploitation of foreign employment seekers by recruiting agencies and travel agents; (ii) Take steps to encourage women employment seekers abroad and implement strict legal procedures for preventing exploitation of women going abroad for employment; (iii) Encourage the export of skilled workers with high potential demand (e.g. nurses) in the world market; (iv) Instruct the Bangladeshi missions in different countries to provide necessary support and help to protect the legal and other rights of the migrant workers (especially women workers) as per the law and regulations of the country.

**Other measures:** (i) Take effective measures to lobby strongly for duty-free entry for RMG exports to USA; (ii) Raise the quality control infrastructure to the international level especially in case of commodities for which SPS measures are important; (iii) Maximize benefits from SAFTA and any other bilateral FTA through setting transparent and clear rules benefiting the country.

24. Recommendations on support to agriculture and the rural economy:

**Support to agriculture:** (i) Support capacity expansion of technology-related R&D, rationalize the agricultural research and extension system, provide marketing support (actively involving the private sector) in various forms to vegetable and horticultural product exporters e.g. providing special warehouse facilities; (ii) Although subsidy to agriculture is a vexing issue in view of the budgetary constraints and its management under the WTO rules, subsidy to fertilizer and diesel for irrigation is necessary to ensure profitability of crop production; (iii) Provide special allowable facilities under WTO rules to firms adopting integrated contract farming, processing, and marketing; (iii) Rationalize the agricultural extension services for technology dissemination and for producing quality and new products for exports; (iv) Review the current distribution system of fertilizer and frame transparent and well-defined criteria for allocating dealership of fertilizer to ensure timely availability at the farmers' level; (v) Support the development of vertically integrated marketing systems (for example, involving the NGOs, private firms, supermarkets) for agricultural products; (vi) Encourage increased output of the fishing, poultry, and livestock sub-sectors especially through providing improved veterinary services and remaining alert against the outbreaks of diseases like Asian bird flu.

**Support to the rural economy:** (i) Set and ensure transparent and consistent rules for developing the rural non-farm sector especially for the agro-farm system and agro-enterprise development including guidelines for food-safety and negotiate favourable terms of access to international markets for rural products; (ii) Facilitate the development of marketing facilities, knowledge-building to accelerate agribusiness development and create environment for more effective participation of the private sector; (iii) Invest in rural infrastructure especially energy and transport; (iv) Address market failures through sharing regular information and adopting transparent rules and regulations.

**Rural energy:** (i) Finalize the new energy policy quickly with adequate attention to rural and renewable energy issues and incorporating clearer guidelines for private sector investment in the power sector; (ii) Give priority to allocation of resources and facilitating policies for private investment in forestry, diffusion of improved stoves, and renewable energy technology such as solar and biogas and techniques such as biogas brickquetting for increasing energy efficiency; (iii) Use energy subsidy efficiently with appropriate targeting to the intended users given both on a fuel basis (such as diesel for irrigation) and on the energy system basis (such as solar and biogas plants); (iv) Adopt an integrated and holistic approach for institutional re-structuring of the sector and examine the feasibility of establishing an Energy Planning, Research and Training Institute in the country.

25. Recommendations on human resource development: quality and equity issues:

**Education:** (i) Review the performance, functioning and composition of SMCs and introduce appropriate changes to strengthen the monitoring mechanism; (ii) For primary and secondary education, put emphasis on provision of learning materials and facilities, take necessary steps to improve and modernize the curricula and teaching methods; (iii) Target the children of the poorest and disadvantaged groups such as ethnic minorities and populations in charlands, urban slums and squatters, displaced population by riverbank erosion; (iii) Promote special skill training courses and informal learning systems for secondary school dropouts and others to assist them in gaining useful skills and knowledge for both wage and self employment; (iv) Restructure the VET system to improve its quality and market relevance; (v) Take targeted measures to bring and retain students from poor and hard-to-reach families in schools and put emphasis, especially at higher levels, on standardization and monitoring of performance; (vi) Adopt disaggregated educational goals by region, gender, income groups and other characteristics and work out corresponding disaggregated budgetary allocations and input provision strategies; (vii) Select some 'model schools' in district towns and rural areas and use these as examples of providing quality education along the lines provided by 'best' schools in urban metropolitan areas; (viii) Set targets for quality improvement for the medium term and provide necessary support for achieving the targets, such as adequate budgetary allocations, incentive package for teachers, stipend and other support programme for children of poorer families especially to complete SSC examination, focus on job creation for the youth (especially those below SSC level) by providing special skill training courses and informal learning systems.

**Health:** (i) Although the epidemiologic transition from communicable diseases of poverty to non-communicable "life-style" diseases is still at an early stage, take steps to reduce risky behaviour (e.g. smoking) especially among the poor population; (ii) Address the factors resulting in low utilization of public health care facilities such as government under-funding, high out-of-pocket expenses at the point of service, poor quality of care, low public perception of availability of quality publicly-provided health services, formal and informal charges, and lack of medicines in public health facilities; (iii) Make the delivery of public health services more effective that requires not just establishing and equipping health centres and hospitals but much more, such as improved health service performance, adoption, if necessary, of alternative delivery mechanisms (such as contracting NGOs to manage and/or take over the provision of public health care providers), institutionalizing motivation as a part of institutional culture, and strengthening selected programmes such as immunization, nutrition, and developing improved knowledge, attitudes and behaviour with regard to behavioural health risk factors; (iv) Implement laws and regulations to strengthen institutions to provide adequate oversight and ensure standards of private providers and develop public-private partnerships in appropriate areas; (v) Facilitate community participation in local health services delivery.

26. Recommendations on social protection issues:

**Safety nets programmes:** (i) Improve targeting outcomes by using geographic targeting more efficiently to direct resources to areas with a greater concentration of the poorest and the target population; (ii) Use more precise, restrictive and easily applicable targeting criteria to clearly identify intended beneficiaries; (iii) Closely involve the local government representatives/ functionaries in all stages of programme implementation; (iv) Reduce leakages by adopting new and innovative features (e.g. use smart cards), strengthening monitoring systems, and increasing public access to information.

**Social welfare programmes:** (i) Take measures to improve the design, targeting and effectiveness of existing programmes; (ii) Undertake a comprehensive review of all programmes and, if necessary, re-orient the focus of government ministries from microcredit programmes to other innovative programmes targeting specific disadvantaged population groups and locations; (iii) Introduce an employment guarantee scheme for a minimum of 150 days over a year for at least one member of all extreme poor households; (iv) Encourage and develop partnerships, if necessary, to introduce health insurance schemes for the poor and vulnerable groups within the purview of developing community health insurance; (v) Undertake a programme for the rehabilitation of the recently evicted hawkers from the street markets of the major cities (especially Dhaka) and the slum dwellers and support the development of their alternative livelihoods. These families may be rehabilitated in khas lands around the cities and the NGOs may be involved in providing microcredit and other support necessary for undertaking viable livelihood options; (vi) Implement long-term solution to the water-logging problem in Bhabadaha and undertake short-term rehabilitation scheme for the victims through providing sustainable livelihoods (with assistance from the NGOs) to them; (vii) Undertake measures to fully implement the MoU signed by the representatives of the trade unions, BGMEA and the government setting minimum wages and ensuring safe working conditions across all establishments in the RMG sector; (viii) Move towards an integrated social security policy (following the example of the comprehensive social security scheme for agricultural workers in West Bengal) in a phase-wise manner. This may start with a low-cost health and safety insurance scheme for the RMG workers for which a fund may be created with contributions from the RMG factory owners, workers, government and international organizations (such as UNFPA). (ix) Create a development fund under the Ministry of Overseas Employment and Expatriate Welfare to run emigrant workers' resource and welfare centres to enhance their skills and ensure their health needs and well-being. Give priority to emigrant women and men under the SME development programme.

#### 4. Concluding remarks

27. The budget for FY08 is presumably the last budget under the current MTMF. The government needs to decide on whether to extend the present MTMF or to frame a new MTMF. Developments over the past four years indicate that actual values of several important parameters have deviated from their projected values in the MTMF having significant implications for achieving the PRSP objectives. This suggests a recasting of the FY08 budget substantially from the projected FY08 parameters in MTMF reflecting the present realities and recent macroeconomic and sectoral developments.
28. The proposed three-year rolling investment programme which will ensure a better alignment of the PRSP targets with the resource allocation system should be given strong institutional roots. Similarly, another priority is to evaluate the experience of implementing the medium-term budgetary framework (MTBF) in selected ministries in order to work out the mechanisms of efficient working of MTBF before expanding it to other ministries.
29. In the FY08 budget, two issues need special attention to ensure its proper implementation. *First*, the institutional framework must be revitalized to ensure that (i) ministries and agencies work together effectively and efficiently to implement the budget as a cross-government document; (ii) various agencies and ministries adopt efficient and effective ways of communicating and coordinating on strategic issues relating to budget implementation; and (iii) effective donor coordination is forthcoming to support the budget priorities. *Second*, effective and regular monitoring of budget implementation, at both ministry/agency and national levels, should be carried out using both input and output indicators. For this, a set of 'core indicators' may be specified for use by the ministries/agencies for review at the national level on a quarterly basis.

## 1. Introduction

The fiscal year 2006/07 (FY07) is an eventful year for the Bangladesh economy. The year witnessed unprecedented political turmoil, resulting in the promulgation of emergency along with the formation of an interim government to run the country. These political developments and associated disruptions in the normal life of citizens along with heightened political, social and economic uncertainties had a significant bearing on the performance of the economy during FY07, especially prior to the installation of the interim government in January 2007. Although the economic life is returning to normalcy since the assumption of office of the interim government, deep scours of the earlier period still remain.

In view of the developments during FY07, the national budget for the fiscal year 2007/08 (FY08) has to focus on three priority tasks: (i) restore normalcy in different spheres of economic and social life; (ii) undertake effective measures against major adversities currently faced by the economy (such as the rising trend in the prices of essential commodities, power shortage and 'fertilizer crisis') by taking both emergency (short-term) and long term measures; and (iii) initiate measures and actions that would pave the way towards high economic growth and rapid social development leading to the achievement of the MDGs within the PRSP framework.

In this context, it is also important to realize that the present interim government has a somewhat limited mandate and it would, therefore, be realistic for the budget to focus more on short-term, urgent, and key concerns facing the economy that would not require deeper and fundamental policy decisions by the government. On the other hand, the budget for FY08 could also take the opportunity of taking 'hard economic decisions' on some key strategic issues that have been plaguing the economy for a long time but the earlier governments were unwilling to act due to the existence of strong pressure groups and/or other political reasons.

This policy brief has been prepared by the Bangladesh Institute of Development Studies (BIDS) for consideration of the government in preparing the national budget 2007/08. The recommendations have been suggested keeping the thrusts of the PRSP in view, especially considering the eight specific avenues (four "strategic blocks" and four "supporting strategies") which have been adopted as the cornerstone of the country's poverty reduction strategy.<sup>1</sup> However, given the large number of issues within the domain of the PRSP, the scope of the recommendations has been kept limited to urgent and strategic areas only that could be covered within the existing budgetary framework and would help to achieve the three-fold objectives (as mentioned above) of the national budget 2007/08.

The report is structured as follows. Following this brief introduction, Section 2 identifies the key challenges to be addressed in FY08 through assessing the major developments in the economy during FY07 and reviewing the current status of achievement of the MDGs. Section 3 examines each of these critical concerns and provides recommendations for consideration in the national budget FY08. Finally, some concluding remarks are made in Section 4.

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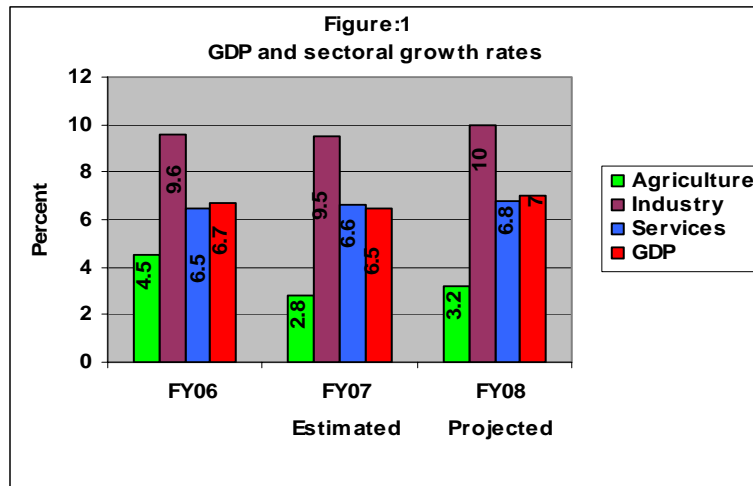
<sup>1</sup> See GOB, *Unlocking the Potential: National Strategy for Accelerated Poverty Reduction*, Planning Commission, Dhaka 2005.

## 2. Major developments in FY07 and key challenges

The fiscal year 2006/07 is marked by some contrasting developments having both positive and negative implications. In view of the absence of the data for the full fiscal year, the present assessment uses, in most cases, six-monthly data (until December 2006) and projections based on current trends, assuming normal conditions would prevail during the rest of the fiscal year.

### Economic growth, savings and investment

Despite major political disturbances, the real sectors of the economy seem to have performed relatively well during the year. The GDP is expected to grow by 6.5% during FY07 as against 6.7% achieved during FY06.<sup>2</sup> The growth in agriculture is likely to be lower (estimated at around 2.8%) than last year's high growth of 4.5% partly due to lower production of rice and partly due to the fact that growth in FY06 showed recovery over previous year's flood damage.<sup>3</sup> A fertilizer and diesel crisis in many parts of the country might have affected the production of boro rice which is yet to be harvested. The industry sector is likely to grow at around 9.5% despite the labour unrest that affected the export-oriented RMG sector during the year. The services sector is expected to follow its trend growth which was 6.5% in FY06. The challenge of sustaining high growth rate, however, is increasingly facing the odds of deficient infrastructure, including power, port, and transport, affecting a wide spectrum of economic activities across rural and urban areas.

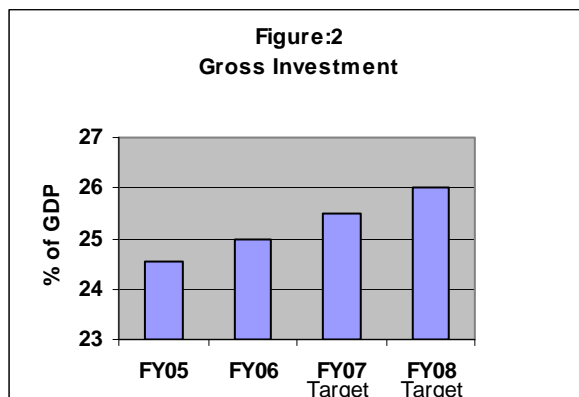


Domestic savings was 20.3% of GDP in FY06 which changed very little in recent years. Given the overall economic situation, it is not likely to change much in FY07. However, national savings (which was 26.6% in FY06) is expected to increase during the current fiscal year due to greater flow of remittances. With a largely stagnating

<sup>2</sup> It may be mentioned here that the government's revised target for GDP growth in MTMF is 6.8% in FY07.

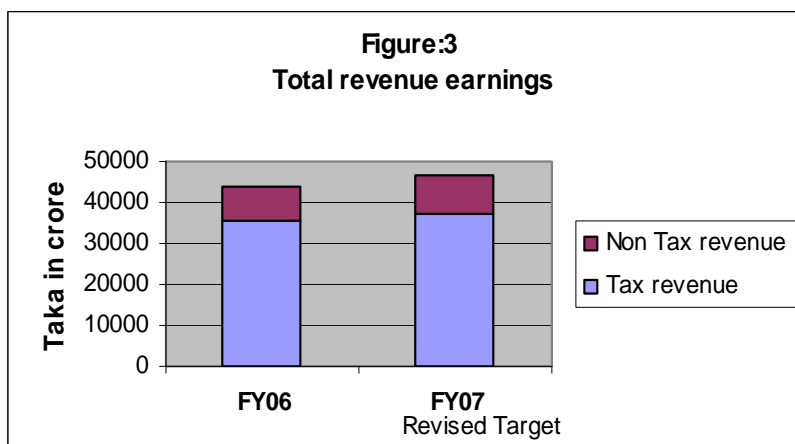
<sup>3</sup> The production of aus rice is estimated at 1.51 million tons compared with 1.75 million tons in FY06 and aman production is unlikely to reach 10.8 million tons of FY06. Similarly, boro production is also likely to be less than 13.98 million tons of FY06.

gross investment-GDP ratio over the last five years, it is unlikely to change much in FY07 from the level of 25% in FY06. In some sense, Bangladesh can be termed as an “under-invested” country having existence of “idle funds” where national savings rate is higher than the gross investment rate.



### Fiscal management

Since independence, Bangladesh inherited a very low revenue-GDP ratio which has changed very little over the years. During FY06, the government’s revenue collection was 10.6% of GDP. During the year, NBR revenues registered a growth of 13.5% over the previous year with a 28.1% increase for direct (income) tax. Value added tax (VAT) also registered a growth of 18.2% and NBR was able to achieve more than 95% of its annual target of tax collection.

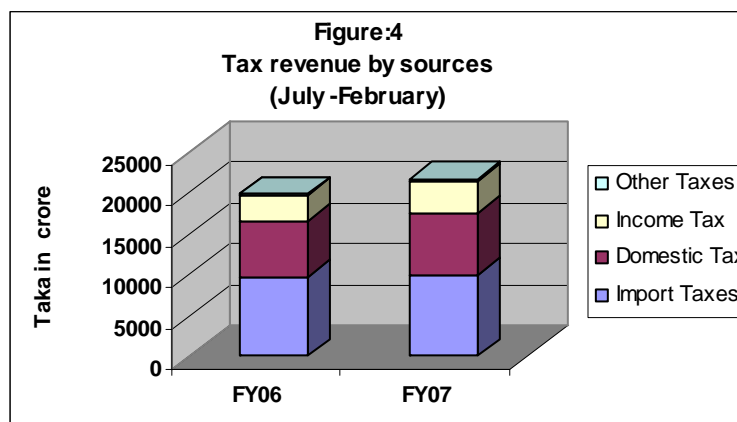


The target for revenue receipt for FY07 was set at Tk. 525.42 billion (11.3% of GDP) which was 17% higher than the revised estimate for FY06. During the first eight months (July 2006-February 2007) of FY07, taxes collected under NBR were Tk.216.52 billion (higher by 9.2% over the same period of the previous fiscal year) but lower by Tk. 57.2 billion of the target during the period. Domestic indirect taxes increased by 14% while the rate was 19% over the same period in the previous year. Disruption in domestic economic activities due to political turmoil is one of the factors in lowering revenue collection. The import-based taxes registered a growth of only

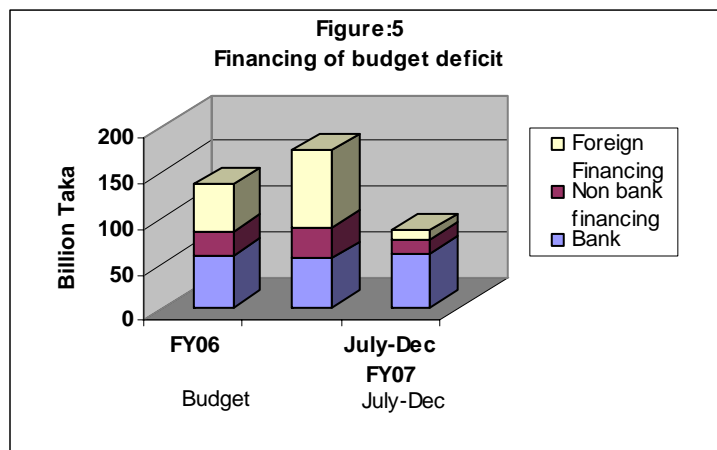
2.7% while supplementary duty at the import stage declined by 27.1% over the first six months. Supplementary domestic duty showed a growth of only 1% during the first six months. Although the growth in overall imports was strong, customs duty collection increased by only 4.1% and import-based value added tax (VAT) by 6% during the first six months due mainly to reduction of customs and supplementary duty rates (e.g. on sugar and motor vehicles). The growth rate of domestic VAT revenue was high at 25.2%. During the first seven months, VAT collection was Tk. 75.1 billion, which was higher by around 11% over the same period of FY06.

On the other hand, income tax collection was Tk. 39.7 billion, which grew by 23% during the first seven months of FY07 and was higher than 15.4% during the same period of the previous year. Such better performance in tax collection can be attributed to drives by the NBR to reduce tax evasion, steps for speedy disposal of income tax cases, scrutiny of income tax returns of the richer groups, measures to expand the number of taxpayers, more effective steps to collect arrears, and speedy disposal of confiscated goods through auction.

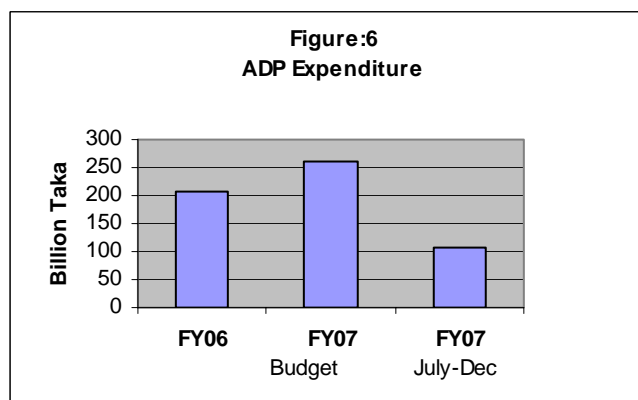
Both slow revenue collection and low aid disbursement adversely affected the projections of proposed financing of the budget deficit. During the first five months (July-November) of FY07, 97.3% of the budget deficit was met by domestic financing with only 2.3% contributed by foreign financing. Net aid disbursement declined by 89% compared with that during the same period of FY06.



During the period, government borrowing from the banking sources increased by 32% and from nonbanking sources by 110% indicating that, unless these trends are not restrained, the government is more likely to overshoot the borrowing targets in FY07.



The planned revenue expenditure for FY06 was 16% higher than that of FY05 while the actual figure was nearly 11% higher than the corresponding figure of FY05. The total size of FY07 budget was set at Tk. 697.40 billion (15% of GDP). The size of ADP was Tk. 260 billion, which was 21% higher than the revised ADP of FY06. It may be mentioned here that the actual expenditure of ADP was only 80% and 85% of planned allocations during FY06 and FY05 respectively. During FY06, the government revised the ADP downwards to Tk. 215 billion while the actual implementation was estimated at Tk. 194.7 billion as compared with Tk. 187.3 billion in FY 05.



The implementation status of the current year's ADP has been very slow, with only about 25% of the funds utilized during the first six months of FY07. Given the present implementation capacity of the public sector agencies, and resource and other constraints, a realistic size of the revised ADP for FY07 should be set at around Tk. 220 billion.

### Monetary developments and inflation

Because of short fall in revenue collection, deficit financing increased significantly during the first half FY07. Total deficit financing by the government during July-December 2006 was Tk. 84.56 billion against Tk. 51.68 billion in July-December 2005.

At the same time, foreign financing of the deficit stood at a lower level of Tk. 10.33 billion during July-December 2006 against Tk. 27.29 billion during July-December 2005 forcing the government to resort to domestic financing of the deficit.

Borrowing from the banking system has been a major means of financing the deficit. In fact, net borrowing from the banking system showed a sharply rising trend since FY 05 and registered nearly four-fold increase in July-December 2006 against the borrowing level during July-December 2005 (Table 1). It may be mentioned here that the national budget estimated net borrowing from the banking system during the current fiscal year to be Tk. 54.34 billion, which has already been exceeded during the first half of the fiscal year.

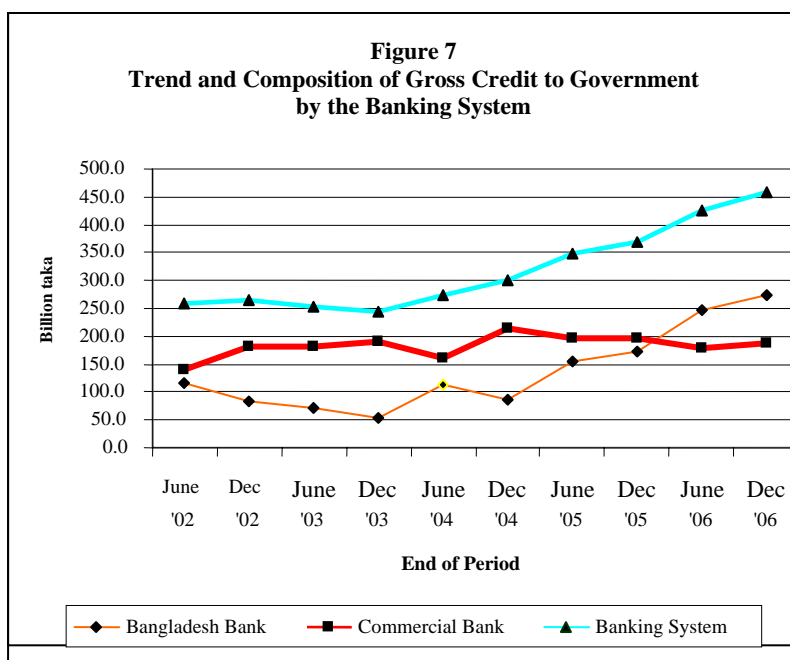
**Table 1: Government borrowing from the banking system**

(in billion Taka)

FY 02	FY 03	FY 04	FY 05	FY 06	July-Dec 05	July-Dec 06
24.87	-11.03	12.46	31.07	56.68	14.96	59.27

Source: Bangladesh Bank, Major Economic Indicators, February 2007

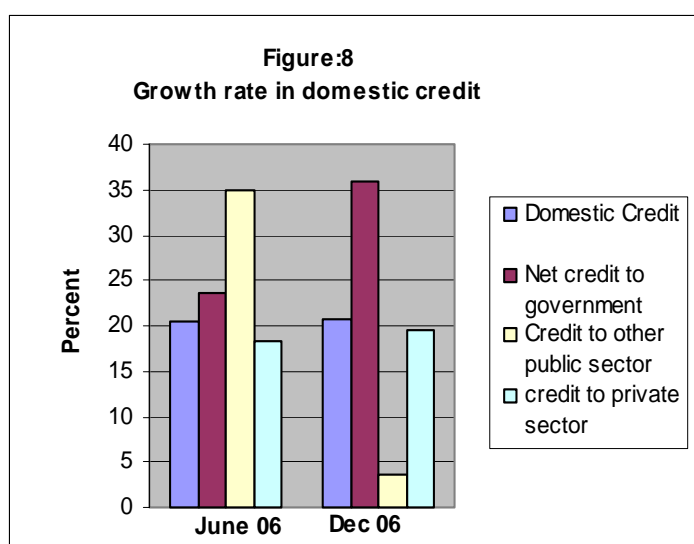
Figure 7 shows the trend and composition of gross credit to the government at the end of half yearly period since June 2002. As is evident, there has been a significant change in the composition of credit to the government by the banking sector since the middle of FY05. Since then, rising demand for credit to the government has been met exclusively by the Bangladesh Bank while credit to the government from commercial banks showed a declining trend.



Such a high level of government borrowing from the Bangladesh Bank contributed towards rapid increases in high powered money. At the end of December 2004, reserve money stood at Tk. 266.5 billion and net foreign assets and net credit to government accounted for 61.4% and 34.3% respectively of the source of reserve money. By the end of December 2006, reserve money increased to Tk. 462.5 billion

and nearly 92.4% of this increase was due to increase in net credit to the government. Accordingly, the share of net foreign assets in the total source of reserve money declined to 43.9% and while that of net credit to government increased to 58.9% in December 2006.

The impact of increase in high powered money on money supply can be observed in the growth of broad money, deposits and money multiplier (Table 2). It shows that the growth of broad money and deposits during the last two years has been less compared to the growth in reserve money resulting in a slight decline in reserve money multiplier. The annual growth rate of broad money (M2) was recorded at 22.3% in December 2006 compared with 17.2% in December 2005. Private sector credit growth increased to 19.4% and net credit growth to the government increased to 35.9% in December 2006 compared with 18.3% and 27.0% respectively in FY06.



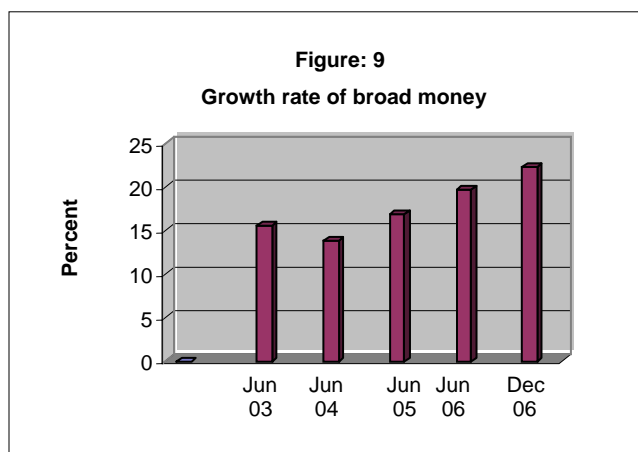
The reserve money increased by 38.2% in the year ending December 2006 from 25.6% in December 2005. Growth of credit to other public sector, however, slowed down from 34.9% in FY06 due to reduced borrowing by the BPC to finance oil imports. It thus appears that, in spite of the restrained monetary policy stance followed by the central bank, total credit, especially credit to the government, has already expanded rapidly and the need is to moderate the trends to avoid any crowding out effects and further pressure to the upward inflationary trend.

**Table 2: Money multiplier and growth in broad money and deposits**  
(in billion Taka)

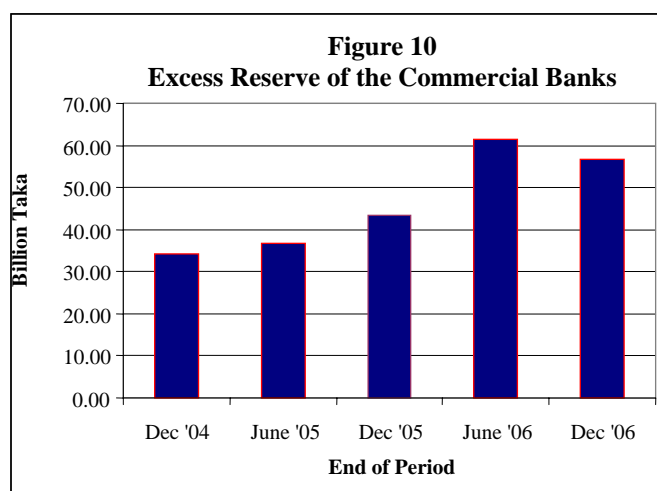
End of period	Reserve money	M <sub>2</sub>	Reserve money multiplier	Credit to private sector	Deposits
Dec '04	266.46	1406.4	5.28	1003.2	1235.5
June '05	295.47	1515.9	5.13	1094.3	1328.9
Dec '05	334.64	1647.8	4.92	1167.0	1440.5
June '06	378.63	1811.6	4.78	1281.2	1577.6
Dec '06	462.51	2015.8	4.36	1423.0	1710.8
Yearly growth (%)	31.7	19.7		19.1	17.7

Source: Bangladesh Bank, Major Economic Indicators, February 2007

The above analysis shows that recent increases in government borrowing from the Bangladesh Bank have contributed significantly to the growth in reserve money, which in turn has been largely responsible for the observed growth in broad money. Although the growth in private sector credit has been much less compared with the growth in high powered money but, given the dominant share of the private sector in the total credit disbursed (nearly three-fourths), the rapid growth in credit to the private sector also contributed to the growth in money supply.

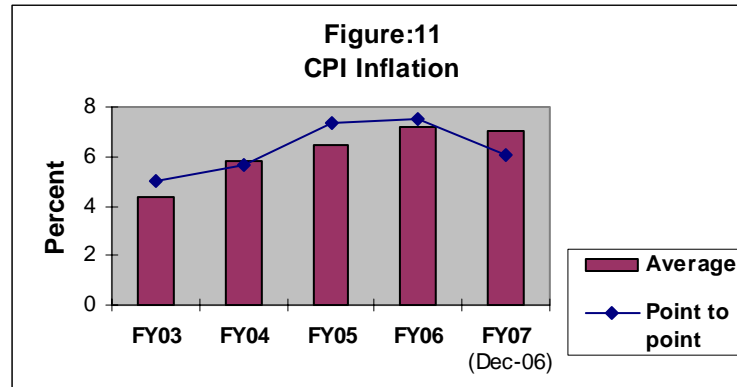


Although the Bangladesh Bank has been following a restrained monetary policy for the last two years but the policy has not been much successful in restricting the growth of credit and money supply. The phenomenal growth of credit to the government is a major reason behind this failure, while the growth of credit to the private sector has largely to do with the persistence of inflationary expectations and also the rising trend in excess reserve maintained by the commercial banks with the Bangladesh Bank (Figure 10).



In January 2007, Bangladesh Bank announced its policy to maintain a broad money growth target of 14.7% and a domestic credit growth target of 14.1% for FY07.

Achieving these targets, however, would require retaining a tightened monetary policy stance and restrained bank borrowing by the public sector.



The point to point inflation rate increased from 6.8% in July to 7.3% in October 2006. A slight decline to 7.1% is estimated for December 2006. The target is to contain annual average inflation to 7% in FY07 compared with 7.2% in FY06. At present, strong inflationary pressures exist in the economy and containing inflation at the projected level would require actions on both demand and supply sides, including moderating the upward fluctuations in food prices, softening of nonfood prices through ensuring smooth supply and optimal inventory accumulation, pursuit of cautious monetary policy, and socio-political and financial stability.

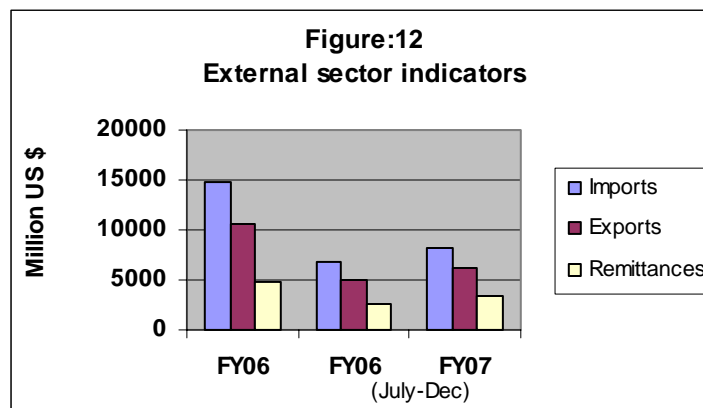
### External sector developments

Developments in the external sector have been encouraging so far. Export earnings during FY06 stood at US\$ 10.5 billion showing a growth rate of 24.7% over the previous year. The export target for FY07 has been set at US\$ 12.5 billion. During the first seven months (July 06 to January 07), total export earning is estimated at US\$ 7039.7 million (about 0.45% lower than the target for the period) but higher by nearly 21.4% of the actual export earnings during the same period of FY06. The growth targets for items like woven wear, frozen food, engineering products, processed food and leather products were exceeded but exports of knit wear, leather and raw jute fell short of their targets. While export diversification is yet to take a satisfactory pace, it could be possible to attain the export target for FY07 provided aggressive efforts are made to address the existing bottlenecks.

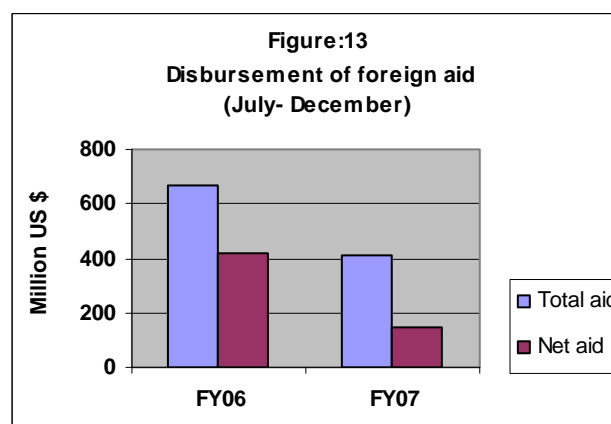
Total imports during FY06 amounted to US\$ 14.8 billion indicating a growth rate of 12.2% over the previous fiscal year. Imports grew by 20.7% during July-November 2006 compared with 10.9% during the corresponding period of 2005. At the disaggregated level, imports of foodgrains and fertilizer declined by 3.1% and 53.7% respectively whereas increases were recorded for sugar (61.9%); consumer goods like milk, spices, edible oil, oilseeds, and pulses (34.8%); industrial raw materials (25.3%); and capital machinery (27.6%). The record on opening of letters of credit for imports indicates persistence of high import growth at least during the first half of FY07.

The trade deficit during July-November 2006 increased to US\$1,165 million from US\$ 1,132 million over the same period of 2005 due to higher absolute size of imports. The

current account recorded a surplus of US\$302 million mainly due to the surge in remittances. Remittances totalled US\$ 4.8 billion in FY06, which was 25% higher than the level of FY05. During July-January of FY07, remittances grew at a healthy rate of 29%. The overall balance during the first five months of FY07 showed a surplus of US\$ 157 million from a deficit of US\$ 463 million during the same period of FY06. Foreign exchange reserves rose to more than US\$ 4 billion at the end of December 2006.



The gross disbursement of foreign aid during FY06 was US\$ 1,241 million (less by 1.5% of the amount during FY05) while the net foreign aid inflow was US\$ 752 million, which was 7.3% lower than the corresponding figure of FY05. The disbursement of foreign aid in FY07 is also likely to follow the declining trend, which has already created a severe pressure on the domestic sources of borrowing. A key challenge in this respect is to create conditions for quick disbursement of budgetary support through the PRGF and Development Support Credit (DSC).



In terms of the major macroeconomic aggregates, a summary of the MTMF targets as given in the PRSP and actual performance for FY06 is given in Table 3. For FY07, since the data on actual performance cannot be given at this time, the budget value is given and the likely achievement of the targets is indicated based on the current trends.

## Major sectoral developments

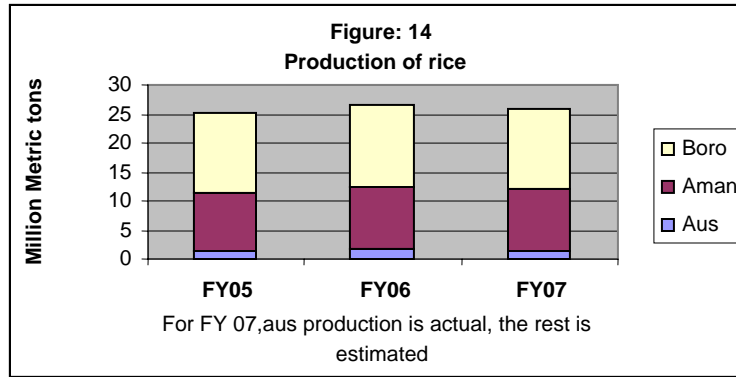
Agricultural growth is likely to slow down in the current fiscal year (presently estimated at around 2.8%) compared with 4.5% in FY06 mainly due to lower production of rice. Along with natural factors (such as insufficient rainfall during aus and aman cultivation and transplant season) and short supply of critical inputs like fertilizer, diesel, insecticides and better quality seeds affected aus and aman harvests in many parts of the country and is likely to affect the boro harvest as well. Domestic rice prices are relatively high, so the farmers have incentives to increase rice production. The important issue is to ensure adequate supply of good quality seeds and other necessary inputs in the market and undertake institutional and other measures to avoid any disruptions in the supply chain like the fertilizer shortages during the current

**Table 3: MTMF and actual performance of selected macroeconomic indicators**

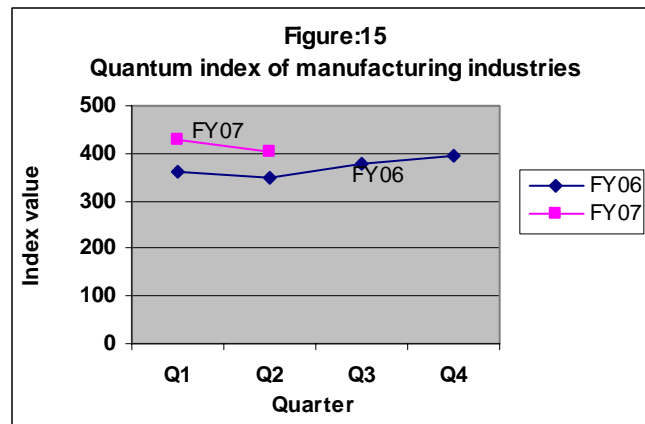
Indicators	FY 2006			FY 2007		
	MTMF Performance target	Actual/est. value	Index *	MTMF Target	Budget value	Likely outcome**
Real GDP growth rate (%)	6.50	6.70	103	6.80	...	—
CPI inflation, average, (%)	6.50	7.04	108	6.00	...	+
Gross domestic investment (% of GDP)	25.00	24.97	99	25.50	...	—
Total revenue (% of GDP)	11.00	10.78	98	11.30	11.29	—
Tax revenue (% of GDP)	9.00	8.69	97	9.30	9.22	—
Non-tax revenue (% of GDP)	2.00	2.09	105	2.00	2.07	+
Total expenditure (% of GDP)	15.50	14.67	95	15.70	14.99	—
Current expenditure (% of GDP)	8.60	8.90	104	8.80	9.09	+
ADP (% of GDP)	5.90	5.17	88	6.20	5.59	—
Overall budget deficit (% of GDP)	4.50	3.89	86	4.40	3.70	+
Net financing (% of GDP):						
Domestic	2.00	1.96	98	1.90	1.90	+
Banking system	0.90	1.18	131	0.80	1.17	+
Non-banking sources	1.10	0.78	71	1.10	0.73	+
Foreign	2.50	1.93	77	2.50	1.80	—

Note: \*Ratio of actual/estimated value to MTMF target in percent. \*\* '+' sign means actual outcome is likely to achieve/exceed the MTMF target while a '-' sign means the opposite.

fiscal year. The outlook for other crops is reported to be encouraging this year along with greater efforts on the part of the farmers to diversify to high value crops and horticultural products. Measures are needed to build on these successful efforts through technological, infrastructural, marketing and other support. The prospects for other sub-sectors in agriculture like livestock, poultry, fisheries, and forestry is good and these are likely to grow at their trend rates.



The industry sector grew at a rate of 9.6% in FY06, with large and medium-sized firms emerging as the principal drivers of growth. Evidently, under the present structure, Bangladesh's industrial growth is strongly linked with its export performance (especially through the RMG sector). In spite of the recent labour unrest, RMG exports have not been affected and the sector seems to be gaining momentum in the post-MFA era. The construction sector has also been maintaining its growth momentum (which grew by 8.4% in FY06) and would probably show higher growth due to recent high growth of remittances. It is likely that the industrial sector would show a growth of around 10% in FY07.



With a highly heterogeneous composition, some service sector activities (e.g. trade and transportation) are related to agricultural and industrial performance while many other components have shown high autonomous growth (e.g. telecommunications, mobile phone, computer and internet services, health care and education services, and financial intermediation). Many of these sectors have grown at rates faster than the GDP growth rate in recent years and this is likely to continue during FY07. The growth rate of the services sector was 6.5% in FY06 and this is likely to be marginally higher in FY07 (due mainly to disruptions in many service sector activities resulting from political disturbances).

## Recent status of MDG indicators

For Bangladesh, the MDGs are more than mere aspirations and shared global objectives; these are the pillars of national progress as adopted in the PRSP. The progress achieved so far in terms of major MDG indicators is given at Annex 1. In general, the table shows that Bangladesh has made significant progress in many areas of human and social development and is “on track” to achieve the MDG targets for most of the indicators. However, there also exist several areas of concern, particularly in important sectors like health, education, gender equality, and in ensuring environmentally sustainable growth.

The last mentioned issue has become a critical area of concern because of the fast eroding natural resource base as well as the severe degradation of its quality due to human activities related to waste generation and disposal. Not only the full potentials of sectors such as agriculture are remaining unrealized, this is also slowing the rate of eradication of poverty. Furthermore, the failure to manage waste properly, particularly in the urban areas and in the industrial belt has posed severe threats to human health putting pressure on the national exchequer to allocate scarce financial resources to combat the adverse effects. Preventive measures which are less costly to avert the future catastrophe are therefore necessary.

Moreover, Bangladesh has a long way to go even if the MDGs are achieved. For example, even if we are able to halve the population who live in poverty by 2015 (MDG1), still nearly 47 million people would remain poor and more than 22 million would be living in extreme poverty in 2015. It is also important to realize that future progress towards achieving the MDGs would require maintaining the present trend and, in certain cases, increasing the current rate of progress. For this, increasingly more efforts and resources would have to be devoted to achieve the same level of success as the easier options are exhausted and the compulsion would be to address the more difficult cases.

## Critical areas requiring attention in FY08 budget

This brief review of the performance of the economy during FY06 and the status of achievement of the MDG indicators bring out nine challenging areas that need to be addressed in the national budget of FY08 in order to achieve the three-fold objectives as mentioned in the introduction of the paper. These are summarized below and the proposed recommendations to address these challenges will be given in the next section.

- **Re-setting investment priorities for sustaining growth momentum:** Macroeconomic fundamentals; productivity growth in agriculture; major bottlenecks in infrastructure; improvement in investment climate.
- **Management of inflation:** Both demand-pull and cost-push dimensions of inflation; inflation-related trade policy issues; institutional measures to ensure reasonable prices of essential commodities.

- **Resource mobilization:** Measures to broaden the tax base and increase the efficiency of tax administration; tax rationalization; measures to increase non-tax revenues, capital market development.
- **ODA inflows:** Reverse the declining trend in net ODA inflows; PRGF and DSC support.
- **Size and quality of public expenditure:** Rolling investment programmes and MTBF; ADP size and project quality; sectoral allocations.
- **Sustaining export growth:** Export growth and export diversification.
- **Support to agriculture and the rural economy:** Areas of support, adequate and timely supply of fertilizer, diesel and other inputs; demand and supply side bottlenecks of rural non-farm enterprises and SMEs.
- **Human resource development-quality and equity issues:** Adequate, affordable, and equitable access to quality education and healthcare services.
- **Social protection issues:** Strengthening existing programmes; new programmes for hardcore and vulnerable poor and displaced persons.

### 3. Recommendations for the national budget FY08

#### 3.1 Re-setting investment priorities for sustaining growth momentum

The GDP growth rate in FY07 is likely to be lower than FY06 (see section 2) and hence, in order to meet the poverty reduction goals, Bangladesh should aim at a GDP growth rate of around 7.0% during FY08. For achieving this, priorities are to: (i) enhance the low agricultural growth experienced this year; (ii) address some major infrastructural bottlenecks such as inadequate power generation and inefficient distribution, low quality transport network that requires immediate emphasis on modernizing the railway network, construction of Dhaka-Chittagong expressway, and improving the functioning and facilities of Chittagong port. Private and foreign collaborations may be availed in implementing many of these projects.

In addition to ensuring macroeconomic stability, the cornerstone of the growth acceleration policy of the FY08 budget would be: (i) increasing productivity across all sectors of the economy; (ii) undertake measures to promote a commercially viable energy sector;(iii) install better economic governance and a vastly improved investment climate; (iv) maintain macroeconomic stability; and (v) undertake measures to ensure better and more equitable availability of financial services. In this respect, some key recommendations are the following (for agriculture, the recommendations are given under *support to agriculture and the rural economy*).

#### **Recommendations on re-setting investment priorities for sustaining growth momentum**

**Macroeconomic fundamentals:** The recommendations for specific areas are given in respective places in other boxes.

**Manufacturing sector:** (i) Minimize power supply constraints and the frequency of power outages; (ii) vigorously promote Bangladesh's ability to attract FDI in manufacturing;; (iii) initiate measures to improving access to quality tertiary (especially technical) education to address human capital deficiencies; (iv) implement a well-thought out sequence of trade liberalization measures; (v) ensure

adequate flow of credit to manufacturing activities and induce the banks to lower the rate of interest for commercial borrowing.

**Power sector:** The power sector is in the midst of a long-term crisis. Development of the sector should receive a high priority with adequate allocations in FY08 budget along with measures to attract foreign and/or private investment. (i) Undertake measures to urgently make available “the captive power” existing in different establishments to the national grid; (ii) Rehabilitate the currently closed small but viable power generating units on an urgent basis to augment short-term power supply; (iii) Use load management in a judicious manner to minimize the losses to the production sectors of the economy; (iv) Undertake a scrutiny of all proposals of new power generation projects and provide quick approval to viable projects (both short and long-term ones) following rules and regulations in a transparent manner; (v) Initiate actions to import electricity from neighbouring countries (e.g. Bhutan and Nepal) through negotiating transparent terms; (vi) Energy pricing is a vastly complicated issue which has been widely politicized. The government needs to come forward to institutionalize a “formula approach” to determining domestic fuel prices linked with world market prices and other considerations; (v) Address critical governance issues in the power sector, particularly those relating to the power purchase agreements which need to be reviewed. The present “cost plus” system needs to be changed to a “price cap” or “yard-stick” pricing to prevent fraudulent activities.

**Transport and port sector:** (i) Implement policy and institutional reforms at Chittagong and all other sea and land ports; (ii) Implement complementary trade facilitation measures including increasing custom bonded facilities and developing inter-connection transport infrastructure; (iii) Undertake measures to modernize the railway system (with support from development partners) and initiate the construction of Dhaka-Chittagong expressway with foreign collaboration; (iv) Implement the Jamuna bridge link project.

**Services sector:** (i) Provide incentives for developing private industrial estates; (ii) Modify the SME refinance project of the Bangladesh Bank such that credit funds do not disproportionately flow to trading activities; (iii) Open special window for “women entrepreneurs” for SMEs in all banks; (iv) Expedite the implementation of the ongoing financial sector reform programme including restructuring of the NCBs; (iv) Develop objective criteria for bank licensing, subject all banks to regular audits to ensure long-term viability, and review and reform the legal framework for bank failure resolution; (v) Strengthen regulatory and supervisory frameworks for capital and insurance markets; (vi) Expedite the scrutiny of applications by the SEC so that new IPOs can be floated quickly.

### 3.2 Management of inflation

While both demand and supply side factors are responsible for fueling inflation in the economy, the current inflationary trends are heavily influenced by the supply side factors, including sharp rises in international prices of several essential commodities like crude oil, rice, wheat, sugar and other items for which the country is highly import-dependent.<sup>4</sup> The upward adjustment of domestic oil prices and depreciation of the exchange rate also contributed to the upward inflationary trend. There are other factors as well, such as oligopolistic control in imports by a few large importers, and disruptions in the supply chain due to recent drive against unscrupulous importers and hoarders. Under the situation, the tight monetary policy pursued by the government has not been very effective in controlling the cost-push factors that contributed more towards increasing the inflationary pressure. The recent financial statistics suggest that increased deficit financing by the government from the central bank has probably contributed more to the inflationary process than the expansion of credit to the private sector. For reducing inflationary pressure, several institutional measures are also necessary to reduce the negative roles of speculation and ensure more effective working of the market forces.

One possible measure that the government is contemplating to tackle the current inflationary trend is to reduce import tariff on essential food imports. Such a measure can have significant implications for revenue earnings since import tariff still constitutes

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<sup>4</sup> Demand-pull and cost-push forces of inflation can emanate from both exogenous and endogenous factors. Also, there seems to exist a relationship between inflation and growth in the economy.

a major source of tax revenue for the government. The revenue implications of tariff reduction on some essential food imports are given at Annex 2. For managing inflation, the following recommendations are made.

#### **Recommendations on management of Inflation**

**Supply augmentation:** (i) Adopt some short-term measures to augment the supply of essential consumption goods and critical inputs through reducing custom duty, supplementary duty and other surcharges;

**Price adjustment:** (i) Any increase in oil prices, especially of diesel and kerosene oil, should be done gradually to avoid any major shock to the productive sectors of the economy and the poorer groups;

**Administrative and other measures:** (i) Adopt effective administrative measures to liquidate any syndication of the import trade that may exist, bring a competitive environment in import trade, and prevent large-scale smuggling of imported commodities like diesel, kerosene oil, edible oil and fertilizer; (ii) Encourage small importers (if necessary by forming groups) to participate in import activities for which the banks may provide incentives such as through reducing L/C margin and providing easy access to other financial services; (iii) Ensure fiscal discipline as a complement to tight monetary policy in curbing inflation; (iv) Undertake effective measures through the trade bodies and other channels to ensure the genuine importers that there will be no barrier and harassment for law abiding business; (v) Form an independent *Commission on Market Surveillance of Essential Commodities* with representatives from relevant government ministries, importers, trade bodies, consumers and other concerned stakeholders to monitor market situation including prices, stocks, domestic availability, pipeline imports, demand forecasts and other indicators to regularly produce and publish advanced quarterly reports so that appropriate actions can be initiated to avoid any market instability; (vi) Reorganize the Trading Corporation of Bangladesh (TCB) into an autonomous commercial organization to regularly engage in imports of essential commodities so that it can retain some market power to avoid any unforeseen fluctuations in supply and availability of essential imported commodities; (vii) Undertake measures to promote efficient market institutions including rules and regulations so that the presently ruptured “market and import chains” can be mended rapidly through effective measures such as regaining confidence of traders by stopping unnecessary anti-hoarding drives (maintaining normal level of stocks and speculation are regular business activities in a market economy), remove any entry barriers that may exist in import trade to bring competition and remove the existence of so-called ‘syndicates’, restructure and strengthen BSTI to ensure quality and non-adulteration and undertake other confidence building measures for doing fair business. A “crack down” approach is not a viable alternative to solving the ills of the economy; rather the need is to follow a systematic institution building process.

### **3.3 Resource mobilization**

It has already been apprehended in section 2 that the target growth in revenue collection in FY07 is unlikely to be achieved despite the usual practice of collecting more revenues during the last quarter of every fiscal year.<sup>5</sup> However, revenue collection during this fiscal year is likely to be higher than usual due to the special drive by the NBR, other relevant organizations and the law-enforcing agencies to collect arrear taxes, utility fees and other charges from the defaulters. This could, however, remain a ‘one-shot’ jump in revenue collection unless such drives are sustained and a culture of collecting and paying taxes regularly is developed and institutionalized. In the FY07 budget, the target for total revenue earnings was set at Tk. 525.42 billion of which NBR tax revenue was expected to contribute Tk. 415.5 billion.

In Bangladesh, the tax-GDP ratio is around 9% which has increased very little over the years although the recommendation of the Revenue Commission 2003 was to increase the ratio at the rate of 0.45% per year in real terms. An important drawback of

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<sup>5</sup> In total revenue, the share of taxes is about 80%. Tax effort (tax revenue as a % of GDP) increased only marginally from 7.8% in FY01 to 8.6% in FY 05 while non-tax revenue remained stagnant at around 2% of GDP.

the existing system is that, although tax reforms reduced the revenue earnings from trade taxes, compensating increase in tax yields did not take place through augmentation of income and domestic taxes. The MTMF targeted a revenue-GDP ratio of 11.3% and a tax-GDP ratio of 9.3% in FY07. These targets are unlikely to be met and a major effort of FY08 budget should be to substantially gear up the revenue mobilization efforts. The target for NBR tax revenue earnings for FY07 has already been revised downwards to Tk. 372.97 billion.

In the case of income tax, the present number of tax payers is extremely low (although the number of persons having TIN was around 1.78 million, the number of tax payers was about 1.35 million including 42,777 corporate tax payers in March 2007).<sup>6</sup> Some estimates using the Household Income and Expenditure Survey (HIES) 2005 data show that there are about 3.2 million rural households and more than 2.2 million urban households who have an yearly income of more than Tk.120,000, so that these households are potential income tax payers under the existing rules. This shows the wide scope that exists in the country of spreading the net of income tax if effective measures are taken to expand its coverage.

### **Enlarging the tax base**

A very narrow tax base, due mainly to the existence of a large informal sector and the 'underground economy', is a major problem in increasing revenues in the country. The coverage under income tax, as indicated above, is very low, and the return from land revenue, which is fixed in nominal terms per unit of land, declines over time due to its inherent price and income inelastic nature.

Obviously, as a potentially large source, expanding the tax base requires more effective measures to collect more revenues from land taxes and agricultural income. Many other weaknesses in the tax structure also persists which need urgent attention.<sup>7</sup> For example, the contribution of the services sector, which accounts for about 50% of the GDP, is only 3.8% of the total tax yield of the country.<sup>8</sup> The need is, therefore, to take effective measures to avail the existing potentials of raising tax revenues across all sectors of the economy.

While reforming the tax system covers diverse issues in Bangladesh, FY08 budget needs to urgently address two important aspects: (i) *provision of tax holiday; and (ii) provision of zero import duty.*

### **Tax holiday system**

The corporate income tax holiday, as a tax incentive to promote capital investment, is being used for a long time in Bangladesh. The cost of capital does not remain time-invariant under the system as the corporate income tax rate rises after the holiday is

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<sup>6</sup> In 2001, the total number of assesses was less than 0.66% of the total population. At the end of June 2001, the number of persons with TIN was nearly 1.08 million, whereas the number of assesses was 0.86 million. However, only 0.45 million of persons actually paid income tax which is only 52% of the number of assesses. Similarly, the number of tax payers is only 42% of the number of persons having TIN, making the number of TIN as misleading for measuring income tax coverage.

<sup>7</sup> See, GOB Final Report of the Revenue Commission, 2003.

<sup>8</sup> Although a large part of the services sector comprises of small and informal activities, the ability of the formal part of the sector to pay taxes is only partially tapped. At present, only a few of these potential sources have been brought under the tax net.

finished. If a firm enjoys tax holiday, its capital investment does not bear any tax at all if the nature of its investment is of short-term nature so that it fully depreciates before the end of the holiday. On the other hand, the effective tax rate on long-lived machinery of a holiday-enjoying firm depends on the relation between tax depreciation and true economic depreciation. Even though the firm is exempt during the holiday, it must pay taxes on income generated by holiday investments once the holiday is finished. In the literature, it has been shown that the effective tax rate on depreciable capital during the holiday is positive (negative) if the tax depreciation rate (plus inflation rate with historical cost valuation of capital) is more (less) than the true economic depreciation rate.<sup>9</sup> Therefore, short-lived assets bear no tax during the tax holiday but long-lived assets may be penalized by the tax holiday.

Thus, if Bangladesh's objective is to encourage investment in structures and other durable capital, the tax holiday seems to be a poor tax incentive in comparison with other potential tax incentives. Accelerated depreciation or an investment tax credit that leads to zero or negative effective tax rates encourages long-term investment. These tax incentives mean a lower loss in tax revenue as well because, unlike the situation in a tax holiday, taxes remain on other assets used by the firm. In fact, it is argued that an investment tax credit or an investment allowance that applies to capital expenditure can induce the same amount of new long-term investment as a tax holiday can but at less revenue cost because the tax holiday allows the firm to earn rents without paying taxes.

In the past, the provision of tax holiday has been administered in a highly differentiated manner to companies for newly set-up industrial undertakings, physical infrastructure facilities, and tourist industries. The quality and the quantity of incentives accrued to the beneficiaries varied across various provisions of the tax holiday system, such as duration of tax holiday, sector in which tax holiday was granted, geographical location of the establishment, and the period of investment. According to location, tax holiday is allowed for 5 years in Dhaka and Chittagong divisions (excluding the three hill districts) and for 7 years in other parts of the country from the month of commercial production or operation. The firms must apply for a tax holiday status, and not all firms qualify. The tax holiday provision for the treatment of depreciable assets requires that depreciation deductions be claimed in the year, but unused deductions may be carried forward and this deferral of depreciation deductions makes the tax holiday much more generous to the firms. The provision of carrying forward the loss of initial years for adjustment against income of later years also exists.

If a firm is granted a holiday, it usually does not qualify for other tax incentives, such as accelerated depreciation. Overall, the differential structure of the incentive scheme created various anomalies in and abuses of the system. Often, strong pressure groups were able to extend the tax holiday period prior to its expiry. It is also not very clear how far the provision of tax holiday has contributed to successful industrialization in the country.

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<sup>9</sup> This rule applies when the firm cannot defer its tax depreciation write offs. The tax holiday provisions for the treatment of depreciable assets vary considerably among countries. Bangladesh requires that depreciation deductions be claimed in the year, but unused deductions may be carried forward. However, if a firm earns taxable profits during a holiday, it is likely that the firm would fully use these depreciation deductions during the holiday rather than carry these forward.

It thus appears that there is a strong justification to discontinue the tax holiday system in the FY08 budget. The existing provision of granting accelerated depreciation allowance (ADA) at the rate of 80% of the actual cost of machinery or plant for the year in which the unit starts commercial production and 20% for the following years could be retained. Meanwhile, an in-depth evaluation of the entire incentive structure needs to be undertaken and, based on its recommendations, an efficient and transparent system should be installed.

### **Zero import duty**

With trade liberalization and rationalization of the tariff structure, import duty rates have been substantially reduced resulting in declining revenues from import duty. At present, Bangladesh imposes four tariff slabs (0%, 6%, 13% and 25%) in the custom schedule and the average applied MFN duty excluding preferences is about 16.5%. It is estimated that nearly half of the items at the 8-digit HS code level presently fall under the zero import duty category which accounts for about 8% of the total number of tariff lines.

One major item in the zero import duty category is capital machinery. However, its composition is anomalous and highly differentiated.<sup>10</sup> The system seems to have been abused and generated corrupt practices of tax evasion by inadmissible items through using zero-duty status.

One way of rationalizing the system would be to abolish the provision of zero import duty altogether and replace it by a low slab (say 2.5%) to cover import of all capital machineries, auxiliary machines, accessories and parts (up to a certain proportion of the value of the machinery) for all types of industries. This would retain investment incentives on the part of the entrepreneurs and will make the system transparent and less susceptible to abuses and corruption.

### **Non-tax revenue**

It is important to tap new sources of non-tax revenues along with rationalizing fees and charges of existing sources and plugging the loopholes. The rapidly expanding telecommunication sector is a potential source from which substantial revenues can be generated such as through framing appropriate rules for legalizing VOIP.<sup>11</sup> In the past, Bangladesh missed out a number of opportunities of collecting revenues, such as through collecting license fee from mobile phone operators and earning a fair share from the exploration and exploitation of gas. This should not happen in case of coal and other natural resources where substantial revenues can be earned through

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<sup>10</sup> For example, only selected industries are allowed to import capital machinery at zero duty rate. Discrimination is also made amongst industries regarding whether import of auxiliary machines or machine parts would be included under the zero-duty slab. For instance, textile machinery of certain category is exempted from duty but auxiliary machines and parts are not. Similarly, while knitting machines are exempted, industrial sewing machines are subject to duty. In case of poultry, imports of both machinery and machine parts are exempted from duty whereas imports of machinery and parts in dairy, processed food and drink making industry are taxed. Many such examples may be cited which show that the provision is not rational and is subject to misuse.

<sup>11</sup> Raising tax on SIM card of mobile phone may not be a good option, since the demand for mobile phone is highly price elastic and total revenue earnings can be increased by low taxes that would increase the demand for mobile phone and its accessories.

instituting proper royalties and production sharing arrangements with foreign collaborators.

A significant area where priority action is needed for both accelerating growth and increasing revenues is to modernize and expand the port facilities (e.g. Chittagong port) and increase its capacity and efficiency to serve not only the domestic economy but also the regional economy (e.g. eastern states of India and Nepal). Similarly, potentials like sale of carbon emission credits and other new areas can be explored to enhance public resources.

### **Efficiency of tax administration**

The on-going reform in the tax system needs to be geared up and systemized to put in place a modern tax system with simplified assessment and payment procedures along with a more transparent and accountable tax administration. This, along with efforts to augment more resources, is also contingent upon creating a decentralized and empowered local government system.

### **Capital market development**

Monthly turnover of the Dhaka Stock Exchange (DSE) sharply increased in recent months. In January 2007, this was Tk.16.2 billion, nearly 105% higher than in December 2006. Market capitalization also went up to Tk.377.4 billion and the general index rose to 1,805 at the end of January 2007. The Chittagong Stock Exchange (CSE) followed similar trends.

Despite these positive trends, market capitalization to GDP ratio is low (about 7.5%) compared with other South Asian countries. This needs to increase rapidly so that entrepreneurs can finance new businesses, and small savers and investors can share the benefits of growth and corporate profit. The government can assist readily by privatizing profitable state-owned enterprises through offering of public shares including those of the petroleum distribution companies and the Biman.<sup>12</sup> In addition, major mobile companies with huge annual turnover should be strongly urged (if necessary compelled) to offload some of their shares.

#### **Recommendations on increased revenue mobilization:**

##### **1. Personal income tax:**

**Expanding the tax base:** (i) Conduct administrative drives (in areas where potential taxpayers are likely to be high and current coverage is low) to expand the tax base, further simplify tax return procedures, improve administrative efficiency and conduct surveys to identify potential taxpayers; (ii) Make it compulsory to quote/present TIN for holding credit cards, membership of clubs, admission of children in expensive private institutions like kindergartens and universities, membership in professional organizations and similar other places; (iii) Further enhance the scope and coverage of the Large Taxpayers' Unit.

**Tax assessment:** (i) Abolish the provision of regularizing "black money" through paying a nominal tax; (ii) Implement a built-in system of strong deterrence and punishment against willful tax evaders and non-compliers; (iii) Review the existing personal income tax rate and restructure it to be more progressive.

##### **2. Corporate income tax:**

**Exemptions and allowances:** (i) Abolish all exemptions and allowances and/or minimize in special cases; (ii) Discontinue the tax holiday facility and replace it by either ADA or a uniform reduced tax rate;

<sup>12</sup> For example, the Dhaka Electric Supply Company and the Power Grid Company of Bangladesh have already sold their shares in the stock market.

(iii) Abolish the exemptions of tax in respect of capital gains and, in deserving cases, these may be taxed at preferential rates; (iv) Extend the purview of the highest corporate tax slab (45%) applicable in the cases of banks and insurance companies to include other profit making service industries such as in the telecommunication sector; (v) Implement a time-bound plan to ensure that all units of the corporate sector implement harmonized and international accounting standards as adopted by the ICAB to ensure proper tapping of the corporate profit tax; (vi) Rationalize the structure of corporate tax in line with those of neighboring countries in view of the free trade arrangements under SAFTA.

### **3. Customs duty:**

**Rationalization:** (i) Abolish zero rate of duty except in cases where international treaty or obligations exist or strong humanitarian reasons prevail; (ii) Eliminate all concessionary rates and, if any duty concession is given under special circumstances, it should be approved by the Parliament before or within three months; (iii) Eliminate all dispersions of duty rates within 4-digit tariff heads; (iv) Discontinue the practice of making mid-term changes of duty through SRO except in special cases like natural disasters and other emergencies; (v) Enhance supplementary duty on vehicles for personal use and other items generally used by the richer segment in society; (vi) Overhaul the PSI services to remove existing loopholes.

**Procedural reforms:** (i) Reform the customs clearance process to make it more efficient and less time-consuming following recommendations (Appendix II) of Revenue Commission Report 2003; (ii) Discontinue the diplomatic bonded warehouses; (iii) Conduct a review of duty drawback, rates and coefficients and revise accordingly; (iv) Regularly review and frame adequate safeguard duty rules to combat unfair international trade.

### **4. Value added tax (VAT):**

**Expansion of VAT net:** (i) Progressively expand the VAT net every year to cover all potential products and services including secondary agricultural products.

**Registration and collection:** (i) Streamline the registration system at division office level; (ii) Streamline existing VAT rules and orders and simplify the forms and procedures; (iii) Undertake measures to introduce VAT inclusive MRP for all products; (iv) Use VAT stamps of different denominations for 'hard-to-tax' areas; (v) Collect turnover tax from larger SMEs.

### **5. Other taxes:**

**Local level taxes:** (i) Local level taxes are yet to be a major source of revenue while subventions to local governments are a major drain on the national exchequer. Remedying these would necessitate several institutional and policy changes. While the government may look up the Report of the Local Finance Commission set up in the mid-1990s, there is a scope for rationalizing the Immovable property tax as well as the urban land development tax. The latter, particularly should be imposed at a high rate so that land does not remain unutilized and unproductive for long. (ii) Impose location-specific higher and differential tax rates for land used for residential and commercial purposes in large cities (e.g. Dhaka, Chittagong and other city corporations) and apply the same principle in other cities and upazila headquarters.

**Land development tax:** (i) Make upward revision of the tax rate; (ii) Bring large agricultural landowners under the tax net; (iii) Impose location-specific higher and differential tax rates for land used for residential and commercial purposes in large cities (e.g. Dhaka, Chittagong and other city corporations) and apply the same principle in other cities and upazila headquarters.

### **6. Non-tax revenue:**

**Land registration:** (i) Abolish all discretionary power of Sub-Registrars and simplify registration procedure; (ii) Rationalize land valuation by increasing existing rates to reflect market prices in different locations; (iii) Rationalize the minimum value of flats and buildings for tax purposes reflecting current market prices and locational variations.

**7. Licensing of TV, radio and motor vehicles:** (i) Collect a one time license fee at prescribed rates during purchase. The seller will be responsible for the collection of the fee and appropriate administrative arrangements should be designed for implementation; (ii) Review the current structure of registration fee for motor vehicles and work out a schedule that introduces very high fees for high-capacity and expensive cars for personal use.

**8. Tapping special funds:** (i) Access special funds for specific development interventions (e.g. in the energy sector) under international protocols. Under the Kyoto protocol of the UNFCCC, the government may access funds under the instrument of Clean Development Mechanism applicable for developing countries (including the LDCs) for setting up power plants using natural gas, rehabilitation of industrial boilers serving as a source of substantial energy loss and deforestation.

**9. Capital market development:** (i) Simplify the tax filing procedures e.g. treat the 10% tax at source on dividend income as final settlement (similar to tax at source on interest income from bank deposits); (ii) Review the existing provision of corporate tax for listed and non-listed companies. The tax differential between these two types of companies may be increased from 30% and 40% to say, 30% for listed and 45% for non-listed companies to put pressure on non-listed companies to become listed; and set a minimum limit (e.g. 25% excluding pre-IPOs, institutional placements, and the quota for mutual funds) for off-loading shares to the public for consideration as a listed company; (iii) Place a time frame for the currently listed companies to off load at least 25% (or more) of their shares to the public for being treated as a listed company for tax purposes. Similarly, put a limit on holding the maximum number of shares of a company by its sponsors in order to be considered as a listed company for lower tax purposes; (iv) A limit could be placed on the extent to which a company can charge a premium on its IPO as well as on the issue of right shares in the public interest; (v) Divest the shares of profitable SOEs to increase the supply of good shares in the stock markets.

### 3.4 ODA inflows

Despite the commitment that bold initiatives will be taken by the development partners and the global community to complement its pro-MDGs strategies in the post-PRSP era with increased financial assistance, ODA inflow to Bangladesh shows a declining trend. Reversing the trend of declining off-take of foreign aid will be a major challenge for the FY08 budget. This would require addressing the issues of the changing pattern of donor-recipient relationship in recent years, such as changing focus on medium-term outlook rather than short-term lending, from project-based lending to sector-wide approach and policy-based lending, and from bilateral to collective approach to aid commitment and aid disbursement which have brought new dimensions in the volume of aid inflows and aid administration. There is also a widespread perception that much of the aid that Bangladesh has received so far has not been as effective as it could have been in its fight against poverty. For many reasons, ODA has not always been well prioritized, coordinated, or delivered in ways that achieve our objectives. It is important for the FY 08 budget to assess the implications of the above in terms of actual aid inflows in implementing the budget agenda. The following recommendations are made.

#### Recommendations on ODA inflows:

**Increase ODA inflows:** (i) Take initiatives to release, as much as possible, the project aid stuck in the ever-growing pipeline; (ii) Give priority to address the problems of management and implementation capacity of the aid-financed projects, resolve procurement issues, and ensure timely approval of projects and regular provision of matching domestic resources; (iii) Improve the quality of government-donor relationship and its effectiveness to address the issue of poorly-designed projects and provide support to the priorities in the PRSP agenda; (iv) Undertake effective steps to improve the access to budgetary support especially through IMF support under the PRGF together with the Development Support Credit which are contingent upon fulfilling several targets in specific areas and other conditionalities. A review of these conditionalities may be undertaken under the changed circumstances and mutually agreed upon ones may be re-set.

### 3.5 Size and quality of public expenditure

Although the size of public expenditure in Bangladesh is low (around 15% of GDP) compared with other South Asian countries, the scope of increasing public expenditure is limited unless revenue mobilization efforts are streamlined to generate increasingly more revenues and the quality of expenditure is substantially increased.<sup>13</sup> Despite its relative low size, the implementation capacity of ADP is limited. For example, only about 25% of the total funds have been utilized in the first six months of the current fiscal year.<sup>14</sup> There are two major shortcomings of the current practice of preparation and implementation of ADP. *First*, the size of ADP is artificially inflated mostly due to political reasons without any back up of available resources and the ADP invariably contains too many projects (which are beyond the capacity of respective agencies to implement in an efficient manner within the stipulated time period). Moreover, many of these projects are of questionable quality and do not fit with the priorities of the government. Over the last five years, on average, the original ADP was revised

<sup>13</sup> The public expenditure-GDP ratio is around 18-20% in most other South Asian countries.

<sup>14</sup> The situation has been similar in all fiscal years in the past. For example, During FY06 only 37% of the allocated resources in the ADP was utilized in the first eight months of the fiscal year.

downwards by nearly 10% of its original size and the actual implementation was around 90% of the revised ADP. *Second*, the usual practice is to speed up the implementation rate by the ministries towards the end of the fiscal year in order to achieve the ADP expenditure targets resulting in huge wastages, inefficient use of resources, and corruption.

In the ADP of the current year, a total of 886 projects were included with an ADP size of Tk, 260 billion. Of these projects, 428 projects do not have approval and actual financial allocations. A closer scrutiny of the individual projects indicates that many of these projects are of questionable quality, do not fit with the national priority, and were included in the ADP largely due to political considerations. The government is currently working to reduce the size of the ADP by nearly 15% at Tk. 220 billion, mainly to reduce the budget deficit.

The quality of public expenditure has always remained a major issue of concern of the country's public expenditure programme. In the past, efforts were made to identify the major limitations of the current system of development project formulation, its review and the approval process, and the preparation of the ADP. The Report of the Public Expenditure Review Commission (PERC) came up with a set of comprehensive recommendations on these issues but very few of these have so far been implemented. The budget for FY08 should take steps to implement the important recommendations of PERC, which have a direct bearing on the quality of public expenditure. The following recommendations are made.

New areas of concern related mostly to natural resource erosion and degradation are also emerging. The heavily polluted waters around Dhaka, arsenic menace, water logging in many coastal areas need urgent attention and financial, human resources and skills and institutional capacity building are necessary to face these challenges.

#### **Recommendations on size and quality of public expenditure**

**Size of public expenditure:** (i) Make a conservative and realistic estimate of the size of public expenditure with a minimum increase of non-development expenditure; (ii) Limit the size of FY08 ADP at a level of around Tk. 230 billion, which will be about 5% higher than FY07 revised ADP.

**Quality of public expenditure:** (i) Undertake a serious exercise of review of all projects included in FY07 ADP and drop all projects of dubious quality using criteria suggested by the PERC; (ii) Limit the total number of projects included in FY08 ADP at a manageable level and include only approved projects in line with the budget and PRSP priority objectives and for which resources are available; (iii) Further streamline the procedure of selection of new projects (iv) Give priority to selection of projects for which external assistance is available through the pipeline and which fit with our priorities; (v) Direct more resources to on-going projects which have made the most progress so that the benefits can be realized within a short period; (vi) Give priority to projects in critical sectors like agriculture, power, and social sectors.

**New areas of public expenditure:** (i) Public expenditure along with support to community initiatives are necessary to provide people with safe drinking water and protect them from the adverse health impacts of heavily polluted physical environment. The monies may be used for developing necessary skills, increasing community resilience and technical interventions. Collaboration across the board among the Government, NGOs, communities and the private sector may be necessary for this.

### **3.6 Sustaining export growth**

Although export growth and the overall external sector situation are sound and satisfactory at present, the FY08 budget should take appropriate measures to sustain the robust trends in growth of exports and remittances along with moderating import demand. Despite good progress, Bangladesh needs to take several measures to

promote export competitiveness and export diversification.<sup>15</sup> In particular, trade facilitation procedures are cumbersome and infrastructure bottlenecks are severe. The country needs to expand its ability to integrate into the global supply chains rapidly through appropriate measures to enhance domestic competitiveness and improve labour skills. Some recommendations are as follows.

#### **Recommendations on sustaining export growth**

**Trade policy issues:** (i) Further rationalize import tariff on raw materials and extend bonded warehouse facility, in selected cases, for potential export industries like pharmaceuticals, plastic and melamine products, and processed food products; (ii) Take effective measures to diversify the export basket such as through providing budgetary support to promote potential export industries like the ICT sector; (iii) Encourage assembling industries through tariff incentives on CKD and SKD components in a time bound manner to lead to full fledged local production activities; (iv) Set up central bonded warehouse for the RMG sector with adequate safeguards against pilferage to reduce lead time in the post-MFA competitive environment; (v) Take special measures (e.g. fiscal incentives) to attract European investment as joint venture in potential export industries to diversify export basket to EU under EBA facility. (vi) Strengthen the capacity of the BSTI in general and more specifically for testing the quality of products under SPS provisions of WTO and harmonize national standards with both regional and global standards (both Codex and EU-specific).

**Remittances:** (i) Streamline rules and procedures to stop the exploitation of foreign employment seekers by employment agencies and travel agents; (ii) Take steps to encourage women employment seekers abroad and implement strict legal procedures for preventing exploitation of women going abroad for employment; (iii) Encourage the export of skilled workers with high potential demand (e.g. nurses) in the world market; (iv) Instruct the Bangladeshi missions in different countries to provide necessary support and help to protect the legal and other rights of the migrant workers (especially women workers) as per the law and regulations of the country.

**Other measures:** (i) Take effective measures to lobby strongly for duty-free entry for RMG exports to USA; (ii) Raise the quality control infrastructure to the international level especially in case of commodities for which SPS measures are important; (iii) Maximize benefits from SAFTA and any other bilateral FTA through setting transparent and clear rules benefiting the country.

### **3.7 Support to agriculture and the rural economy**

Agriculture, and the rural economy as a whole, is currently faced with a number of challenges. Agriculture must improve its productivity in the face of a shrinking land base, agricultural production must be diversified especially to high-value crops, and the rural non-farm sector must grow rapidly to support employment creation, high growth and faster poverty reduction. Agricultural growth in the current fiscal year is projected to grow at a lower rate than the previous year and the FY08 budget needs to take measures to reverse this trend.

Higher agricultural growth requires, in addition to domestic consumption, technological advancement (at a steady rate of at least 1% per year), quality extension services, and exports of agricultural goods that necessitates the setting of standards, efficient marketing and related services. Also it is important to take measures against land degradation and stabilization of agricultural income in the face of incipient climate changes.

Agriculture in Bangladesh receives limited support from the government, which is allowed under the WTO rules. The 'Green Box' support that Bangladesh can give has no limit, but the actual support given by Bangladesh is only about 2% of the total value of agricultural production. In the case of 'Amber Box' support, subsidies provided to

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<sup>15</sup> Bangladesh's export base is heavily concentrated in the RMG sector, contributing nearly 80% of total merchandise exports.

fertilizer and irrigation also fall far short of the limit of 10% of the value of agricultural production.<sup>16</sup>

Although the number of non-farm enterprises is estimated at about 4 million in 2003 with an employment of around 9 million, several key investment climate weaknesses are holding back the growth potential of the rural non-farm sector.<sup>17</sup> Most of the rural micro, small, and medium enterprises lack adequate access to basic inputs and services.

Another key issue in developing the rural economy is the extremely low availability of energy.<sup>18</sup> The investment in rural energy, especially in the forestry sector and renewable energy, has always been low and inadequate to meet the minimum energy needs of the rising population. The situation demands appropriate changes in policy, resource allocation, technology, and institutions. The country's energy policy must incorporate the issues of rural energy in a coherent and comprehensive manner. Policies must be designed to facilitate private investment in the forestry sector to augment the supply of biomass. The sustainability of solar homes programme is yet to be ascertained while biogas projects are yet to make any perceptible impact on the rural energy situation. All these programmes are highly subsidized while the implications are largely unknown. The institutional structure of the energy sector also needs rationalization that would allow taking an integrated view of energy development and its relationship with the development process. The following recommendations are made.

#### **Recommendations on support to agriculture and the rural economy**

**Support to agriculture:** (i) Support capacity expansion of technology-related R&D, rationalize the agricultural research and extension system, provide marketing support (actively involving the private sector) in various forms to vegetable and horticultural product exporters like providing special warehouse facilities; (ii) Although subsidy to agriculture is a vexing issue in view of the budgetary constraints and its management under the WTO rules, subsidy to fertilizer and diesel for irrigation is necessary to ensure profitability of crop production in the face of weather uncertainties; (iii) Provide special allowable facilities under WTO rules to firms adopting integrated contract farming, processing, and marketing; (iii) Rationalize the agricultural extension services for technology dissemination and for producing quality and new products for exports; (iv) Review the current distribution system of fertilizer and frame transparent and well-defined criteria for allocating dealership of fertilizer at the farmers' level to ensure timely availability; (v) Support the development of vertically integrated marketing systems (for example, involving the NGOs, private firms, supermarkets) for agricultural products; (vi) Encourage increased output of the fishing, poultry, and livestock sub-sectors especially through providing improved veterinary services and remaining alert against the outbreaks of diseases like Asian bird flu.

**Support to the rural economy:** (i) Set and ensure transparent and consistent rules for developing the rural non-farm sector especially for the agro-farm system and agro-enterprise development including guidelines for food-safety and negotiate favourable terms of access to international markets for rural products; (ii) Facilitate the development of marketing facilities, knowledge-building to accelerate agribusiness development and create environment for

<sup>16</sup> These supports are needed not only for ensuring profitability to the farmers but also to keep the country's agricultural products competitive in the global market since almost all countries (including India) who compete with Bangladesh provide substantial support to agriculture under WTO provisions.

<sup>17</sup> See, National Private Sector Survey of Enterprises of Bangladesh, 2003.

<sup>18</sup> On an energy equivalent basis, electricity counts for only 1%, while biomass (e.g. firewood, other tree biomass, and cow dung) accounts for 97% with firewood alone accounting for 44% much of which is purchased.

better participation of the private sector; (iii) Invest in rural infrastructure especially energy and transport; (iv) Address market failures through sharing regular information and adopting transparent rules and regulations.

**Rural energy:** Finalize the new energy policy quickly with adequate attention to rural and renewable energy issues and incorporating clearer guidelines for private sector investment in the power sector; (ii) Give priority to allocation of resources and facilitating policies for private investment in forestry, diffusion of improved stoves, and renewable energy technology such as solar and bio gas and techniques such as biogas bricquetting for increasing energy efficiency; (iii) Use energy subsidy efficiently with appropriate targeting to the intended users given both on a fuel basis (such as diesel for irrigation) and on the energy system basis (such as solar and biogas plants); (iv) Adopt an integrated and holistic approach for institutional restructuring of the sector and examine the feasibility of establishing an Energy Planning, Research and Training Institute in the country.

### 3.8 Human resource development: quality and equity issues

Human development is both intrinsic to the definition of what constitutes a good standard of living and instrumental to developing the Bangladesh economy. A foundation of basic education and literacy expands an individual's economic opportunities helping to acquire better jobs with higher and more dependable income. Despite rapid progress in the expansion of education (especially at the primary and secondary levels and among girls), many problems persist and Bangladesh has a long way to go to reach the targets set under the MDGs.<sup>19</sup>

Along with expansion of education at all levels, a more equitable access to quality education is essential to improve the skills of the labour force and to make them more relevant to the market needs.<sup>20</sup> In general, the progress of education in Bangladesh has been pro-poor, with enrolment (and completion) rising faster amongst girls than boys, and faster in rural areas than urban areas. But still inequalities in education are significant and call for sustained action. For the education sector, serious problems still exist with respect to late entry and high repetition and dropout rates, along with the low quality of education at all levels.<sup>21</sup>

The pattern of public expenditure on education is generally pro-poor in that it favours primary and secondary education in which the poor are more prominently represented. However, as the unit cost per pupil is significantly higher in tertiary education (in which children from richer families are over-represented), the children of the rich receive more in per child terms than the children of the poor. This shows that there is still room to improve the poverty focus of education policies and financing.

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<sup>19</sup> See discussion in section 2 on present status of selected MDG indicators and Annex 1.

<sup>20</sup> There exists significant differences in school enrolment at all levels (e.g. primary, secondary, and tertiary) of education between the poor and the non-poor households which become more prominent at higher levels. Recent data show that only 4.4% from the lowest income group has completed the SSC level compared with 41.4% for the highest income group. Although the gender gap has reduced significantly, it is still high at the SSC and higher levels.

<sup>21</sup> In particular, education in Bangladesh suffers from many deficiencies, such as lack of competencies, knowledge, motivation of teachers, and low quality text books. For example, at the primary level, Bangladesh provides only 444 hours of effective student-teacher interaction annually compared with 1,300 hours in other South Asian countries. Teachers' salaries and salary-related expenses claim nearly 96% of the government budget and the government needs to allocate more resources if the critical needs of the sector are to be met. The National Education Policy (1997 and 2001) recommended to increase annual education expenditure from 2.2% to 7% of GDP by 2010.

Moreover, as Bangladesh needs to sustain a level and kind of economic growth that would drive an economic transition to broad-based growth, it will have to diversify manufacturing and exports beyond its risky dependence on a few largely low-wage growth sectors (e.g. RMG) and find alternative sources of decent employment for those who are currently unemployed or employed primarily in low-input, weather-dependent, subsistence-oriented smallholder agriculture. To attract domestic and foreign investment needed for such an economic transformation, Bangladesh requires a substantial increase in the stock of educated workers who can supply the needs of higher-wage, greater value-added economic activities.

Similarly, in the health sector, effective government policies to mitigate the impact of preventable diseases, protect the poor from impoverishing costs of health care, and ensure their access to affordable, essential high quality health care and health education are important for Bangladesh. These are key public goods that increase the stock of human capital and facilitate long-term economic growth. The country's health policy should also take into account the important role that is already being played by the non-state actors (e.g. private sector and NGOs) in providing significant services as well as in mobilizing and managing funds.

In particular, malnutrition remains a serious problem, especially amongst children and mothers. Even the children of the relatively rich are observed to suffer from high rates of malnutrition showing that, while inadequate food access is critical, poor infant and child feeding practices and poor public health also play a significant role. Some recommendations related to education and health are as follows.

#### **Recommendations on human resource development: quality and equity issues**

**Education:** (i) Review the performance, functioning and composition of SMCs and introduce appropriate changes to strengthen the monitoring mechanism; (ii) For primary and secondary education, put emphasis on provision of learning materials and facilities, take necessary steps to improve and modernize the curricula and teaching methods; (iii) Target the children of the poorest and disadvantaged groups such as ethnic minorities and populations in charlands, urban slums and squatters, displaced population by riverbank erosion; (iii) Promote special skill training courses and informal learning systems for secondary school dropouts and others to assist them in gaining useful skills and knowledge for both wage and self employment; (iv) Restructure the VET system to improve its quality and market relevance; (v) Take targeted measures to bring and retain students from poor and hard-to-reach families in schools and put emphasis, especially at higher levels, on standardization and monitoring of performance; (vi) Adopt disaggregated educational goals by region, gender, income groups and other characteristics and work out corresponding disaggregated budgetary allocations and input provision strategies; (vii) Select some 'model schools' in district towns and rural areas and use these as examples of providing quality education along the lines provided by 'best' schools in urban metropolitan areas; (viii) Set targets for quality improvement for the medium term and provide necessary support for achieving the targets, such as adequate budgetary allocations, incentive package for teachers, stipend and other support programme for children of poorer families especially to complete SSC examination, focus on job creation for the youth (especially those below SSC level) by providing special skill training courses and informal learning systems.

**Health:** (i) Although the epidemiologic transition from communicable diseases of poverty to non-communicable "life-style" diseases is still at an early stage, take steps to reduce risky behaviour (e.g. smoking) especially among the poor population; (ii) Address the factors resulting in low utilization of public health care facilities such as government under-funding, high out-of-pocket expenses at the point of service, poor quality of care, low public perception of availability of quality publicly-provided health services, formal and informal charges, and lack of drugs in public health facilities; (iii) Make the delivery of public health services more effective that requires not just establishing and equipping health centres and hospitals but much more, such as improved health service performance, adoption, if necessary, of alternative delivery mechanisms (such as contracting NGOs to manage and/or take over the provision of public health care providers), institutionalizing motivation as a part of institutional culture, and

strengthening selected programmes such as immunization, nutrition, and developing improved knowledge, attitudes and behaviour with regard to behavioural health risk factors; (iv) Implement laws and regulations to strengthen institutions to provide adequate oversight and ensure standards of private providers and develop public-private partnerships in appropriate areas; (v) Facilitate community participation in local health services delivery.

### 3.9 Social protection issues

Providing social protection to the poorest and the vulnerable groups through public action is an important element of Bangladesh's poverty reduction strategy. The current efforts are, however, inadequate due to their limited coverage, small nature of intervention to create any sustainable impact, and deficiencies in design resulting in leakages and mis-targeting. Targeted food transfer programmes that provide relief assistance as well as reduce wealth-related disparities (e.g. education, health, income generation skills, access to infrastructure) cover around 95% of the total safety nets expenditure of the government. The benefits of many of these programmes extend beyond the simple transfer payments and these (e.g. VGD, FFE, VGF) are found to be reasonably well targeted to the poor. The need, however, is to further improve the targeting and reform programme design and administration to increase the positive impact on the poor households.

There has also been a proliferation of various programmes in recent years to meet the minimum requirements of the underprivileged groups of population in the society, such as senior citizen allowance programme, fund for rehabilitation of the acid-burnt and the physically handicapped, fund for mitigating risks due to natural disasters, honorarium programme for insolvent freedom fighters, programme for the assistance of the retarded, seasonal unemployment reduction fund, retraining and employment of voluntarily retired/retrenched employees/labourers, skill development fund for the readymade garments workers, and fund for housing the homeless. The government is also implementing a number of special credit programmes through different ministries/agencies and channeling funds for microcredit to NGOs through PKSF. These programmes, however, suffer from widespread mismanagement, mistargeting and leakages due to their adhoc nature, low allocation of funds, political interference in implementation, and absence of effective involvement of the local government. Although many of these programmes can play an effective role in alleviating poverty and extremely disadvantaged situation of specific groups, a priority is to review their performance and address the shortcomings to make them efficient social welfare measures. The following recommendations are made.

#### **Recommendations on social protection issues**

**Safety nets programmes:** (i) Improve targeting outcomes by using geographic targeting more efficiently to direct resources to areas with a greater concentration of the poorest and the target population; (ii) Use more precise, restrictive and easily applicable targeting criteria to clearly identify intended beneficiaries; (iii) Closely involve the local government representatives/ functionaries in all stages of programme implementation; (iv) Reduce leakages by adopting new and innovative features (e.g. use smart cards), strengthening monitoring systems, and increasing public access to information.

**Social welfare programmes:** (i) Take measures to improve the design, targeting and effectiveness of existing programmes; (ii) Undertake a comprehensive review of all programmes and, if necessary, re-orient the focus of government ministries from microcredit programmes to other innovative programmes targeting specific disadvantaged population groups and locations; (iii) Introduce an employment guarantee scheme for a minimum of 150 days over a year for at least one member of all extreme poor households; (iv) Encourage and develop partnerships, if necessary, to introduce health insurance schemes for the poor and vulnerable groups within the purview of developing community health

insurance; (v) Undertake a programme for the rehabilitation of the recently evicted hawkers from the street markets of the major cities (especially Dhaka) and the slum dwellers and support the development of their alternative livelihoods. These families may be rehabilitated in khas lands around the cities and the NGOs may be involved in providing microcredit and other support necessary for undertaking viable livelihood options; (vi) Implement long-term solution to the water-logging problem in Bhabadaha and undertake short-term rehabilitation scheme for the victims in providing sustainable livelihoods (with assistance from the NGOs) to them; (vii) Undertake measures to fully implement the MoU signed by representatives of the trade unions, BGMEA and the government setting minimum wages and ensuring safe working conditions across all establishments in the RMG sector; (viii) Move towards an integrated social security policy (following the example of the comprehensive social security scheme for agricultural workers in West Bengal) in a phase-wise manner. This may start with a low-cost health and safety insurance scheme for the RMG workers for which a fund may be created with contributions from the RMG factory owners, workers, government and international organizations (such as UNFPA). (ix) Create a development fund under the Ministry of Overseas Employment and Expatriate Welfare to run emigrant workers' resource and welfare centres to enhance their skills and ensure their health needs and well-being. Give priority to emigrant women and men under the SME development programme.

#### 4. Concluding Remarks

The budget for FY08 will be prepared under the medium-term macroeconomic framework. This budget is presumably the last budget under the current MTMF. It will, therefore, be important for the government to take a decision on whether to extend the present MTMF or to frame a new MTMF. Developments over the past four years indicate that actual values of several important parameters have deviated from their projected values in the MTMF having significant implications for achieving the PRSP objectives. This suggests a recasting of the FY08 budget substantially from the projected FY08 parameters in MTMF reflecting the present realities and recent macroeconomic and sectoral developments.

Moreover, the proposed three-year rolling investment programme which is supposed to ensure a better alignment of the PRSP targets with the resource allocation system is yet to take any strong institutional roots to achieve the intended objective. This is an important priority for which necessary actions are needed without any further delay. Similarly, another priority is to evaluate the experience of implementing the medium-term budgetary framework (MTBF) in selected ministries to work out the mechanisms of efficient working of MTBF before expanding it to other ministries.

In the FY08 budget, two issues should also be given special attention in order to ensure its proper implementation. *First*, the institutional framework must be revitalized to ensure that (i) ministries and agencies work together effectively and efficiently to implement the budget as a cross-government document; (ii) various agencies and ministries adopt efficient and effective ways of communicating and coordinating on strategic issues relating to budget implementation; and (iii) effective donor coordination is forthcoming to support the budget priorities. *Second*, effective and regular monitoring of budget implementation, at both ministry/agency and national levels, should be carried out using both input and output indicators. For this, a set of 'core indicators' may be specified for use by the ministries/agencies for review at the national level on a quarterly basis.

**Annex-1**

**Current status of selected MDG indicators and future imperatives**

Goals/Indicators	Benchmark Value Year	Target 2015	Current position	Future imperatives
<b>MDG1: Eradicate extreme poverty and hunger</b>				
1. Poverty rate (%)	58.8 1992	29.4	Poverty rate has fallen to 40% in 2005 and if this rate of decline can be sustained, the target can be achieved. The poverty rate was 61.2% in rural areas and 53.0% in urban areas in 1991/92. These rates declined to 43.8% in rural areas and 28.4% in urban areas in 2005. These declines were achieved despite a rise in inequality, with overall Gini coefficient rising from 0.259 in 1992 to 0.334 in 2005.	Absolute number of the poor is still very high (at about 56 million) with considerable urban-rural and regional disparities. GDP growth needs to reach 7-8%, be broad-based and rural-focused. Also there are issues of increasing inequality and its impact on women and children; there exist a large number of working children adversely affecting the development of the country's new generation of human resources.
2. Extreme poverty rate (%)	28.0 1992	14.0	The extreme poverty rate (as measured by those who consume less than 1,805 kcal per day) declined to 19.5% (17.9% in rural areas and 24.4% in urban areas) in 2005. This means that 27 million of the population still live in hunger and extreme poverty.	Along with better quality of growth, actions are needed to reduce livelihood insecurity, provide infrastructural support, access to financial and other productive assets, and a minimum level of citizenship.
3. Child malnutrition	... ..	...	Progress in reducing child malnutrition (among children aged 0-59 months): moderate or severe underweight (weight-for-age) declining from 56% to 48%, moderate or severe stunting (height-for-age) from 55% to 45%, and moderate or severe wasting (weight-for-height) declining from 18% to 10% between	Child malnutrition continues to remain a serious problem. Integrated approach needed with more effective measures to accelerate progress in poverty reduction, enhance food security along with creating knowledge of better nutrition and health practices of mothers and child.

			1996/97 and 1999/00.	
<b>MDG2: Achieve universal primary education</b>				
4. Net primary enrolment ratio (%)	73.7 1992	100	Rapid progress in net enrolment rate from 64% (male: 68%, female: 60%) in 1990 to nearly 86% (male: 84.6 %, female: 85.4 %) in 2003. The completion rate of the five-year cycle of primary education has also increased from nearly 41% in 1991 to 67% in 2004. The drop out rate is thus extremely high at 33%, This shows that, of about 18 million primary school aged children, nearly 4 million remain out of school and another 4 million or more drop out before completing the primary education.	Need to provide access to the hard-to-reach poor children and improve the quality of education. Quality of incentive programmes should be improved with better targeting.
5. % pupils starting class 1 who reach class 5	42.5 1994	100	The current rate is estimated at 80.6%. Repetition rates are high at 39% implying, on average, a child needs 6.6 years to complete the five year cycle.	More efforts needed to address the lack of quality of education, improve the competency level of primary school graduates, increase insufficient contact hour and reduce unfavourable student-teacher ratio. More resources should be allocated to the education sector along with improved pro-poor focus of incentive programmes and ensure better access to all eligible children, especially from the poor groups and in disadvantaged locations.
6. Adult literacy rate (%)	36.9 1990	...	The literacy rate of population (15 years and over) increased to 50.3% (male: 56.3%, female: 44.2%) in 2003.	Efforts needed to make a significant dent in illiteracy as nearly half of the youth population (15-24 years) enter into the labour force with no education and skills to pursue productive and remunerative earning opportunities. Need emphasis on universal coverage of primary education, and better

				delivery of adult literacy programmes.												
<b>MDG3: Promote gender equality and empower women</b>																
7. Ratio of girls to boys in primary, secondary and tertiary education (%)	<table border="0"> <tr> <td>Primary</td> <td>55:45</td> <td>1991</td> <td>48:52</td> </tr> <tr> <td>Secondary</td> <td>34:66</td> <td>1991</td> <td>50:50</td> </tr> <tr> <td>Tertiary</td> <td>25:75</td> <td>1991</td> <td>50:50</td> </tr> </table>	Primary	55:45	1991	48:52	Secondary	34:66	1991	50:50	Tertiary	25:75	1991	50:50		<p>The ratio of girls to boys in primary education has improved to 48:52, that in secondary education to 52:48 and in tertiary education to 36:64 in 2002. At the secondary level, female enrolment rate increased significantly with girls-to-boys ratio of 53:47 in 2004.</p>	<p>While gender parity at both primary and secondary levels has been a major achievement, bringing the large numbers who are out of school and belong mostly to the poorer groups is a challenge. Also the secondary education system is extremely inefficient: for every 100 students who enter the system at class six, only six survive through passing the HSC examination which is a pre-condition to continue higher education. In this respect, since the overall objective of achieving gender parity and raising secondary school enrolment for girls have been achieved, future actions should concentrate on regions where the largest gender gaps exist and where enrolments are lagging. Since gender parity at the present enrolment level has been achieved, the policy emphasis also needs to design appropriate incentives along with more effective mechanisms for both girls and boys from the poor families to attend and continue in schools.</p>
Primary	55:45	1991	48:52													
Secondary	34:66	1991	50:50													
Tertiary	25:75	1991	50:50													
8. Ratio of literate females to males of 20-24 year olds	42:65	1992	100:100	<p>The ratio is estimated at 55:71 in 2002.</p>	<p>Girls not completing the secondary cycle are seriously disadvantaged in social and economic life. Emphasis needs to be placed on ensuring their access and completion of quality higher education, providing life skills and remunerative job opportunities.</p>											
8. Wage	...		...	The labour force	The majority of women											

employment	...		participation rate of women increased from 14% in 1990/91 to 26.1% in 2002/03 although the rate is far below the rate for men (87.4% in 2002/03). The share of women in wage employment in non-agricultural sector is 22% and of the total employed labour of 44.3 million in 2002/03, only 22% are females.	work for wages in agriculture, in manufacturing or on family enterprises. Also significant gender differentials in wages exist. Investments in building and enhancing the quality of human capital is important for the women workers to move to more rewarding jobs.	
<b>MDG4: Reduce child mortality</b>					
9. Infant mortality rate	94	1990	32	Infant mortality rate per 1,000 live births has declined to 53 (urban: 40, rural: 57) in 2003. About two-thirds of these deaths are due to factors like low birth weight, pre-term delivery and birth asphyxia.	The major factors underlying high infant mortality needs to be addressed through adopting intersectoral approaches to remove the underlying causes. High mortality reflects the care, health, and nutrition status of both children and mothers including social, cultural and economic situations.
10. Under-five mortality rate	151	1990	50	Under five mortality (per 1,000 live births) has declined to 82 in 2001. About half of these deaths are due to neonatal and perinatal causes.	More emphasis is needed on factors like encouraging institutional deliveries, deliveries by skilled personnel, utilization of antenatal care, measures against birth-related ailments and neonatal tetanus, and diseases like pneumonia, diarrhoea, measles. Efforts are needed also to improve care-seeking behaviour and practices and improve malnutrition and vitamin and other micronutrient deficiencies.
11. % of 1-year old children immunized against measles.	54	1991	100	The coverage increased to 69% in 2003.	More efforts needed to creating awareness and providing information, more effective supplementary immunization activities for the drop-outs and more effective involvement of all stakeholders.
<b>MDG5: Improve maternal health</b>					

11. Maternal mortality ratio (per 100,000 live births)	574	1990	143	The maternal mortality ratio has declined to 380 in 2003 (urban areas: 270, rural areas: 400).	The maternal mortality ratio still remains extremely high, especially in the rural areas. These alarmingly high figures call for a careful assessment of the situation and a review of interventions covering attitudes, training, awareness, access to medical centers, and the availability of skilled medical expertise. The approach should consider that still around 95% of the deliveries occur at home.
12. Births attended by skilled health personnel (%)	5	1990	50 (by 2010)	Extremely low at around 12% in 2000.	Progress so far is insignificant; major emphasis needed on all aspects with special targeting to rural areas and low income groups.
13. Total fertility rate	3.3	1990	2.2 (by 2010)	The rate is estimated at 2.8 at present.	Despite increase in contraceptive prevalence rate from 45% in 1994 to 54% in 2000, TFR plateaued and has only recently started to fall at a slow rate. More emphasis is needed to promote safe motherhood from the grassroots level through effective antenatal care, safe delivery, pre-natal care, essential obstetrical care and family planning services. Need is to influence the age of marriage, improve the knowledge, and ensure easy availability of desired methods.
<b>MDG6: Combat HIV/AIDS, malaria and other diseases</b>					
13 HIV, malaria and other diseases				HIV rates are relatively low although potential of spreading the disease is considered to be high. Significant progress achieved in combating and preventing diseases like malaria, small pox, cholera, leprosy, polio	Measures needed to prevent any HIV epidemics and other diseases like SARS and avian flu. More emphasis needed to break the cycle of diarrhoea and other water-borne and common diseases that mostly affect the poor.

			and other diseases.	
<b>MDG7: Ensure environmental sustainability</b>				
15. Access to safe drinking water sources (%)	99 1990 (urban)  76 1990 (rural)	100 (urban)  96.5 (rural)	Although almost 100% of the population has access to water, if the quality of water (especially arsenic contamination) is taken into account, the present coverage is estimated at 82% in the urban areas and 72% in the rural areas.	The coverage can be increased rapidly. Ensuring sustainable access would require use of appropriate and affordable technology for treating naturally-occurring arsenic in tubewells and adoption of alternative safe sources.
16. Access to improved sanitation (%)	71 1990 (urban)  11 1990 (rural)	85.5 (urban)  55.5 (rural)	In rural areas, access has increased to 29% in 2002. For urban areas, however, coverage has dropped to 56% mainly due to unbridled and unplanned urbanization.	More resources and efforts are needed to address the serious challenges of sanitation and associated solid waste management problems.
17. Land area under forest coverage (%)	9 1990	20	Total area under forest increased from 7,367 sq. miles in 1992/93 to 10,029 sq miles (less than 18% of the total land area) in 2002/03.	The approach needs to conserve, develop, and augment forests for meeting socioeconomic needs and ensure sustainable ecological balance and biological diversity, and encourage the use of substitute forest products.
<b>MDG8: Develop a global partnership for development</b>				
18. Official development assistance	... ...	...	Official development assistance (ODA) to Bangladesh has declined from 6.9% of GNP in 1990 to 2.3% in 2005.	Bangladesh's capacity to implement the PRSP is constrained by a chronic shortage of investment funds to meet priority requirements. Current concessions given to Bangladesh is limited and there is a strong justification for increasing assistance since the amount of ODA given to Bangladesh is low compared to that received by many LDCs.

**Estimates of revenue loss from tariff reduction in selected food imports**

The government has been contemplating reduction of import tariff on essential food imports to tackle the current inflationary trend in the economy. Such a measure may result in significant reduction in revenue earnings since import tariff still constitutes a major source of revenue for the government. The present exercise aims at estimating possible revenue loss arising out of such tariff reduction measures.

**Major food imports of Bangladesh and the structure of import tariff**

Table 1 identifies major food imports of Bangladesh at 8-digit H.S. Code<sup>22</sup>. The items have been ranked according to the size of revenue earned against the import of these items during 2005-06. As is evident from the Table, the tax earned from these items stood at around Tk. 27 billion in 2005-06. The tax incidence on these items varied from a low of 0% to a high of 78.8% with the trade weighted average estimated at around 24.0%.

The breakdown of the structure of import tariff for the selected food items has been shown in Table 2. As can be seen from the Table, the trade weighted average rate of custom duty, supplementary duty and VAT for these items are relatively low at 8.8%, 1.8% and 10.8% respectively. However, because of the cascading nature of the supplementary duty and VAT the overall tax incidence works out to be significantly higher (Table 3).

The import tariff indicated in Table 2 prevailed during 2005-06. However, some downward adjustment in the tariff for selected food items was made prior to and during the announcement of National Budget 2006-07. Thus, the budget announced lowering of tax incidence on the import of garlic, turmeric, dried chili, ginger, onion and peas from the prevailing level to 5%. The 20% supplementary duty on sugar was waived prior to the announcement of the national budget reducing tax incidence on the import of sugar from 74.8% to 43.8%. In the budget for 2006-07, the import tariff on sugar was converted to specific duty of Tk. 5000 per metric ton.

**Table 1: Major food imports of Bangladesh  
2005/06**

H.S. code	Item	Assessed value of imports (million Taka)	Revenue <sup>1</sup> (million taka)	Tax incidence (%)
1511.10.00	Crude palm oil	38,189.6	8,971.0	23.5
1701.99.00	Sugar	10,903.9	8,156.0	74.8
1507.10.10	Crude soyabean oil	13,613.0	3,197.7	23.5
0402.21.90	Milk and cream in granules or solid forms	3,562.0	1,767.7	49.6

<sup>22</sup> The figures reflect the picture with regard to recorded imports only. Studies have shown that illegal imports from India constitute nearly 20% of Bangladesh's total recorded imports. Of this illegal import, bulk belong to agricultural and livestock category. Thus, major items of illegal import from India include cattle (41.5%), sugar (6.8%), pulses (5.9%), milk powder (3.4%), spices (3.3%) and rice (2.0%), together accounting for nearly 63% of all illegal imports from India.

1001.90.10	Wheat	22,122.1	1,327.3	6.0
0402.21.10	Milk and cream in powder form	664.9	523.6	78.8
0908.30.10	Cardamom	842.1	454.8	54.0
0909.30.10	Cumin seed	842.1	454.8	54.0
0910.30.10	Turmeric	842.1	454.8	54.0
1006.30.00	Rice	6,822.0	409.3	6.0
0713.10.10	Dried peas shelled	3,386.3	338.6	10.0
0703.10.11	Onion	2,129.9	213.0	10.0
0713.20.10	Dried chickpeas shelled	2,114.0	211.4	10.0
0901.10.10	Cinamon	282.2	152.4	54.0
0713.40.10	Lentils	2,128.0	127.7	6.0
0910.10.10	Ginger	342.5	58.2	17.0
0703.20.10	Garlic	313.5	53.3	17.0
0907.00.10	Clove	67.5	36.5	54.0
0904.11.00	Pepper	64.0	34.6	54.0
1511.90.19	Rbd palm stearin	67.4	24.0	35.6
0904.20.10	Dried chili	92.2	17.2	18.7
0908.10.10	Nutmeg	10.6	3.1	29.0
1507.90.90	Refined soyabean oil	1.1	0.3	23.5
1511.90.90	Refined palm oil	0.9	0.2	23.5
0909.20.10	Coriander	0.7	0.2	29.0
1205.00.11	Oil seed	3,174.3	0.0	0.0
	All	112,579.3	26,987.4	24.0

<sup>1</sup> Excludes advance income tax (AIT)

**Table 2: Structure of import tariff on major food imports: 2005-06**

( in %)

H.S. Code	Item	CD	SD	VAT	AIT	IDSC	Advance trade VAT	Tax incidence
0402.21.10	Milk powder	25	20	15	3	4	1.5	78.8
0402.21.90	Milk in solid forms	25	0	15	3	4	1.5	49.6
0703.10.11	Onion	6	0	0	3	4	0	10.0
0703.20.10	Garlic	13	0	0	3	4	0	17.0
0713.10.10	Dried peas	6	0	0	3	4	0	10.0
0713.20.10	Dried chickpeas	6	0	0	3	4	0	10.0
0713.40.10	Lentils	6	0	0	0	0	0	6.0
0904.11.00	Pepper	25	20		3	4	0	54.0
0904.20.10	Dried chili	13	0	0	3	4	1.5	18.7
0901.10.10	Cinamon	25	20	0	3	4	0	54.0
0907.00.10	Clove	25	20	0	3	4	0	54.0
0908.10.10	Nutmeg	25	0	0	3	4	0	29.0
0908.30.10	Cardamom	25	20	0	3	4	0	54.0
0909.20.10	Coriander	25	0	0	3	4	0	29.0
0909.30.10	Cumin seed	25	20	0	3	4	0	54.0
0910.10.10	Ginger	13	0	0	3	4	0	17.0
0910.30.10	Turmeric	25	20	0	3	4	0	54.0
1001.90.10	Wheat	6	0	0	0	0	0	6.0
1006.30.00	Rice	6	0	0	0	0	0	6.0
1205.00.11	Oil seed	0	0	0	3	0	0	0.0
1507.10.10	Crude	6	0	15	0	0	1.5	23.5

	soyabean oil							
1507.90.90	Refined soyabean oil	6	0	15	0	0	1.5	23.5
1511.10.00	Crude palm oil	6	0	15	0	0	1.5	23.5
1511.90.19	Rbd palm stearin	13	0	15	3	4	1.5	35.6
1511.90.90	Refined palm oil	6	0	15	0	0	1.5	23.5
1701.99.00	Sugar	25	20	15	0	0	1.5	74.8
	All	8.8	1.8	10.8	0.30	0.70	-	24.0

**Table 3**  
**Cascading effect of supplementary duty and VAT: Case of milk powder**

Duty type	Duty Rate (%)	Duty inclusive value (Taka) of imported milk powder (Assessed value = Tk. 100)
Custom duty	25	100(1.25) = 125
Supplementary duty	20	125(1.20) = 150
VAT	15	150(1.15) = 172.5
Development surcharge	4	172.5+100(.04)= 176.5
Advance Trade VAT	1.5	176.5+(150) (.015) = 178.75

#### **Revenue loss due to lowering of tariff**

One factor that is likely to influence the revenue effect of tariff reduction is price elasticity of imports. By way of illustration, we estimated the price elasticity of imports for five food items and worked out the implication for revenue loss over revenue earned in 2005-06, when tax incidence on these imports is reduced by 50% (Table 4). The import demand is found to be quite elastic in all 5 cases and the total loss in revenue on account of these imports is estimated to be about Tk. 4.5 billion. The highest revenue loss is observed in the case of crude palm oil (Tk.3.4 billion), which has one of the lowest price elasticity while the lower revenue losses are observed in the case of onion (Tk. 92 million) and sugar (Tk. 131 million) with relatively high price elasticity.

Of course, these estimates of revenue loss are only indicative as they have been worked out under *ceteris paribus* assumption. The extent of actual loss in revenue will depend on many other factors including growth in the demand for the product, local production of the item, changes in the border price and actual changes that have been made in the duty rates during 2005-06 and now.

**Table 4: Price elasticity of import demand and estimates of revenue loss due to tariff reduction in selected food imports**

H.S.Code	Item	Price elasticity	Estimated loss in revenue over revenue earned in 2005-06 for 50% reduction in tax incidence (million Taka)
0703.10.11	Onion	-1.76	92.2
1701.99.00	Sugar	-2.02	131.2
1006.30.00	Rice	-1.20	191.4
1001.90.10	Wheat	-1.05	623.4
1511.10.00	Palm oil	-1.08	3443.7
	All	-	4481.9