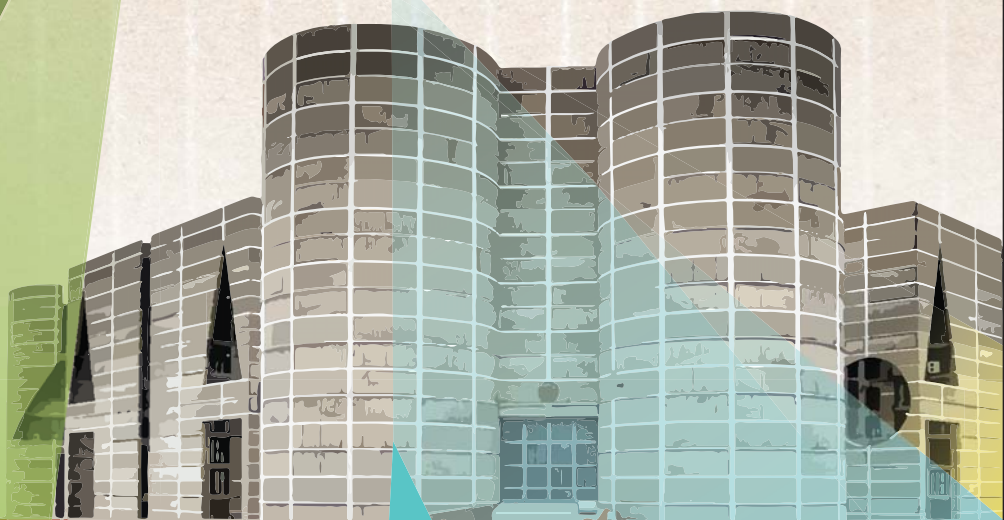


BANGLADESH PUBLIC EXPENDITURE REVIEW *update*



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South Asia Region

June 2015

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BANGLADESH **PUBLIC EXPENDITURE REVIEW** *update*

An update of fiscal trends based on the
2010 Public Expenditure Review



South Asia Region

June 2015

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ABBREVIATIONS AND ACRONYMS

ADP	Annual Development Plan
Agr	Agriculture, fisheries and livestock, land, water resources, and food
ASYCUDA	Automated System for Customs Data
BBS	Bangladesh Bureau of Statistics
BDT	Bangladesh Taka
CD	Customs Duty
CSRS	Civil Servant Retirement Scheme
DSA	Debt Sustainability Analysis
Edu	Education and technology
FE	Fuel and Energy
GDP	Gross Domestic Product
GNI	Gross National Income
GoB	Government of Bangladesh
GPF	General Provident Fund
GPS	General Public Services
GVA	Gross Value Added
HCS	Housing and public works
HDI	Human Development Index
ICT	Information and Communication Technology
IDA	International Development Association
IES	Industries, jute, textiles, commerce, labor and overseas
IMF	International Monetary Fund
LGRD	Local government, R&D and cooperatives, Chittagong Hill Tracts Affairs
MoF	Ministry of Finance
MoP	Ministry of Planning
NBR	National Board of Revenue
NSC	National Savings Certificates
PER	Public Expenditure Review
PER-2010	2010 World Bank Public Expenditure Review

POS	Public Order and Safety
R&D	Research and Development
RADP	Revised Annual Development Plan
RCRA	Recreation, Culture and Religious Affairs
RD	Regulatory Duty
SD	Supplementary Duty
SFYP	Sixth Five Year Plan
SOCB	State-Owned Commercial Banks
SOE	State Owned Enterprise
SRO	Statutory Regulatory Order
SSW	Social Security and Welfare
TC	Transport and Communication
TRIST	Tariff Reform Impact Simulation Tool
US\$	United States Dollar
VAT	Value Added Tax
WBG	World Bank Group
WDI	World Bank World Development Indicators
WEO	IMF World Economic Outlook

BUDGETARY UNITS AND SECTOR MAPPING

The Government of Bangladesh (GoB) classifies budgetary units into higher level sectors. We have maintained this classification throughout this Public Expenditure Review (PER).

Budgetary unit	Sector (short)	Sector (long)
01 - Office of the President	GPS	General public services
02 - Parliament	GPS	General public services
03 - Prime Minister's Office	GPS	General public services
04 - Cabinet Division	GPS	General public services
06 - Election Commission Secretariat	GPS	General public services
07 - Ministry of Public Administration	GPS	General public services
08 - Public Service Commission	GPS	General public services
09 - Finance Division	GPS	General public services
10 - Finance Division - Comptroller & Auditor General	GPS	General public services
11 - Internal Resources Division (IRD)	GPS	General public services
12 - Bank and Financial Institution Division	GPS	General public services
13 - Economic Relations Division (ERD)	GPS	General public services
14 - Planning Division	GPS	General public services
15 - Implementation Monitoring and Evaluation Division	GPS	General public services
16 - Statistics and Informatics Division	GPS	General public services
17 - Ministry of Commerce	IES	Industries, jute, textiles, commerce, labor and overseas
18 - Ministry of Foreign Affairs	GPS	General public services
19 - Ministry of Defense	Defense	Defense
20 - Armed Forces Division	Defense	Defense
21 - Law and Justice Division	POS	Public order and safety
22 - Ministry of Home Affairs	POS	Public order and safety
23 - Legislative and Parliamentary Affairs Division	POS	Public order and safety
24 - Ministry of Primary and Mass Education	Edu	Education and technology
25 - Ministry of Education	Edu	Education and technology
26 - Ministry of Science and Technology	Edu	Education and technology
27 - Ministry of Health and Family Welfare	Health	Health
28 - Information and Communication Technology Division	Edu	Education and technology
29 - Ministry of Social Welfare	SSW	Social security and welfare
30 - Ministry of Women and Children's Affairs	SSW	Social security and welfare

31 - Ministry of Labor and Employment	IES	Industries, jute, textiles, commerce, labor and overseas
32 - Ministry of Housing and Public Works	HCS	Housing and public works
33 - Ministry of Information	RCRA	Recreation, culture and religious affairs
34 - Ministry of Cultural Affairs	RCRA	Recreation, culture and religious affairs
35 - Ministry of Religious Affairs	RCRA	Recreation, culture and religious affairs
36 - Ministry of Youth and Sports	RCRA	Recreation, culture and religious affairs
37 - Local Government Division	LGRD	Local government, R&D and cooperatives, Chittagong Hill Tracts Affairs
38 - Rural Development and Co-operatives Division	LGRD	Local government, R&D and cooperatives, Chittagong Hill Tracts Affairs
39 - Ministry of Industries	IES	Industries, jute, textiles, commerce, labor and overseas
41 - Ministry of Textiles and Jute	IES	Industries, jute, textiles, commerce, labor and overseas
42 - Energy and Mineral Resources Division	FE	Fuel and energy
43 - Ministry of Agriculture	Agr	Agriculture, fisheries and livestock, land, water resources, and food
44 - Ministry of Fisheries and Livestock	Agr	Agriculture, fisheries and livestock, land, water resources, and food
45 - Ministry of Environment and Forest	Agr	Agriculture, fisheries and livestock, land, water resources, and food
46 - Ministry of Land	Agr	Agriculture, fisheries and livestock, land, water resources, and food
47 - Ministry of Water Resources	Agr	Agriculture, fisheries and livestock, land, water resources, and food
48 - Ministry of Food	SSW	Social security and welfare
49 - Ministry of Disaster Management and Relief	SSW	Social security and welfare
50 - Road Transport and Highways Division	TC	Transport and communication
51 - Ministry of Railways	TC	Transport and communication
52 - Ministry of Shipping	TC	Transport and communication
53 - Ministry of Civil Aviation and Tourism	TC	Transport and communication
54 - Ministry of Post and Telecommunications	TC	Transport and communication
55 - Ministry of Chittagong Hill Tracts Affairs	LGRD	Local government, R&D and cooperatives, Chittagong Hill Tracts Affairs
56 - Power Division	FE	Fuel and energy
61 - Supreme Court	POS	Public order and safety
63 - Ministry of Liberation War Affairs	SSW	Social security and welfare
65 - Ministry of Expatriates' Welfare and Overseas Employment	IES	Industries, jute, textiles, commerce, labor and overseas
67 - Anti-Corruption Commission	POS	Public order and safety
71 - Bridges Division	TC	Transport and communication

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EXECUTIVE SUMMARY

This report is an update to a Public Expenditure Review for Bangladesh undertaken in 2010. It aims to analyze the major spending trends since (and before) the PER-2010. This includes the macro-fiscal stance (deficits, debt, etc.) and the allocation of resources within the budget on both a sectoral level (health, education, etc.) and a thematic level (wages, interest, etc.). It notes whether these trends are broadly in line with stated development objectives, and whether the revenue and spending stances are sustainable. It also aims to indicate any potential issues based on the evidence presented in this report and provide an indication of the areas in which improvements or set-backs have occurred since the PER-2010, as well as whether any new issues are emerging. Since this is an Update, it does not go into the same depth as standard PERs. Therefore, while noting the conclusions based on the analysis, this report also indicates where more in-depth analytical work could be undertaken, either to confirm the findings or to gain a better understanding of an issue.

A sustainable fiscal stance

Bangladesh has a good record of low fiscal deficits and sustainable public debt. Over the past decade, Bangladesh achieved an average fiscal deficits of 3.1 percent of GDP and, at 3 percent in FY14, the deficit was well below the South Asia average of 3.7 percent. Deficits also varied within a fairly narrow band, ranging from 2.2 to 4 percent of GDP. While the record in fiscal discipline has been commendable, it stems partly from a lack of capacity among some ministries to spend allocated (development budget) resources. Thanks to contained deficits and strong economic growth, public debt is low and declining as a share of GDP. Public debt declined steadily from 42 percent of GDP in FY06 to 34 percent of GDP at the end of FY14, among the lowest in South Asia. The latest Debt Sustainability Analysis (DSA) found that public debt was sustainable, even in the event of large shocks, including significant borrowing to finance new power plants and partially recapitalize state-owned banks.

However, several risks to fiscal sustainability do exist, many outside of the control of government.

Contingent liabilities related to state-owned banks present particular risks, with potential costs of up to 2.5 percent of GDP, while total guarantees are estimated at around 4 percent of GDP in FY15, including to non-financial SOE. Pension liabilities also present longer-term risks.¹ Other vulnerabilities relate to international fuel prices, as fuel and fertilizer subsidies absorb a significant proportion of the budget, and currency depreciation. These risks could be particularly large if several occur together and the government is not able to issue sufficient debt to cover the payments.

Underwhelming revenue performance

Bangladesh has among the lowest revenue as a share of GDP in the world. A spurt in revenue growth raised revenue from 9.8 percent of GDP in FY09 to 11.2 percent in FY12. It since declined somewhat, leaving Bangladesh with among the lowest revenue to GDP ratio in the world. While tax collections tend to increase in line with economic growth, Bangladesh has, by and large, found it challenging to turn economic growth into revenue growth. As a result, tax revenues (which make up over 80 percent of all revenue) remain below expected for Bangladesh's level of development. In addition, Bangladesh faces the challenge of reliance on "border revenues" – customs, duties and VAT paid on imports – which made up almost 30 percent of total revenue in FY14. Although reliance on border revenues has fallen since

¹ Liabilities related to the Civil Servant Retirement Scheme (CSRS) appear to have been tamed but potential future costs related to the General Provident Fund (an obligatory contributory but unfunded retirement scheme for civil servants) remain.

FY10, this underpins the importance of mobilizing domestic collections as well as considering ways to shore up border revenues with minimal negative economic consequences.

Bangladesh has among the highest corporate taxes in the region but also the lowest “tax effort”. With corporate income tax rates of up to 45 percent, firms face potentially high tax rates. In addition, the Doing Business 2015 survey estimated that businesses require 302 hours per year to pay their taxes, higher than India (243 hours), Sri Lanka (167) or Bhutan (274) but fewer than Pakistan (594).² Tax effort – actual revenues compared to potential collections given the country’s characteristics – are the lowest in the region, averaging 64 percent over the period 2004-12. This is not surprising in a country where less than 1 percent of the total population pays regular taxes. Low collections and low tax effort may reflect a need to simplify taxes and improve the tax administration including by enhancing compliance and reducing corruption.

There have been some positive recent efforts to boost revenue collections. The National Board of Revenue (NBR) developed a Tax Modernization Plan, which is in the process of implementation. Efforts include increased automation of income taxes, the implementation of an Automated System for Customs Data (ASYCUDA) World, and strengthening human resources at the NBR. In addition, a new law to simplify the VAT regime should be implemented from July 2016.

Low public expenditure

With low revenues, the low fiscal deficits reflects low public expenditures. As well as having among the world’s lowest revenues, Bangladesh has the world’s lowest public expenditures, at around 14 percent of GDP in FY14. An inability to absorb resources by some ministries, in both the recurrent and development budgets, contribute to the low expenditure. With significant development needs, including infrastructure requirements, and a weighty poverty challenge, public sector resources must be used efficiently to make progress.

Around two-thirds of the budget goes to recurrent expenditure but there has been a shift toward investment or development over the last five years. Between FY10 and FY14, public expenditure grew by an annual average of around 8 percent. While both recurrent and development expenditure saw significant increases in real terms, the priority clearly shifted toward investment during the period. Public investment grew at an annual average of 14 percent, while recurrent expenditure grew by 6 percent per year. As a result, development increased as a share of total expenditure from 33 to 40 percent.³ Expenditure patterns in both the recurrent and development budgets are broadly in line with the government’s development plan.

Low public expenditures result in some of the region’s most limited public services and poorest infrastructure. For example, Bangladesh spends less on health care than other countries in South Asia and, indeed, less than most countries in the world. Health expenditure per capita was around US\$95 in 2013 compared to \$215 in India, \$126 in Pakistan and \$304 in Sri Lanka. Out-of-pocket costs are estimated at close to two thirds of the total. It is also ranked as having the poorest quality of infrastructure by the World Economic Forum (WEF). The Global Competitiveness Report 2014-15 ranks Bangladesh’s overall infrastructure at 130th out of 144 countries, lower than Pakistan (119th), India (87th) or Sri Lanka (75th). Its road and railway infrastructure perform particularly poorly.

² World Bank/IFC (2014).

³ This includes net lending, much of which is funneled through SOEs and invested. Excluding net lending, investment grew from 27 to 33 percent of the total budget between FY10 and FY14.

Recurrent expenditure dominated by interest payments

Recurrent expenditure increased fast over the last decade and performance falls into two distinct periods driven by interest costs. Recurrent expenditure growth averaged 10 percent per year over the period FY06-11 with non-interest spending driving almost all of this increase. Between FY11 and FY14 total recurrent spending growth slowed to 5 percent per year, as investment expenditure became a higher priority. However, non-interest expenditure growth slowed to a trickle – less than 3 percent – while interest costs increased at around 14 percent per year. Interest costs increased from a decade low of 1.7 percent of GDP in FY11 to 2.1 percent in FY14. This is in a context of a country where revenue rarely reaches 11 percent of GDP.

Interest costs are higher than spending on many social sectors and they may be crowding out other recurrent expenditure. Between FY11 and FY14, interest payments were worth almost the same as was spent on education, or similar to the amount spent on health and social welfare combined. In total, around a quarter of recurrent expenditure went on interest payments in FY14. With limited resources (and low fiscal deficits), increases in interest costs reduce expenditure in other areas. During the past decade, there is a negative relationship between interest costs and other recurrent expenditure.

Social sectors and agriculture priority recurrent expenditures

Social sectors absorb close to 40 percent of non-interest recurrent expenditure but their growth slowed after FY11. Between FY11 and FY14, around 37 percent of non-interest recurrent expenditure went to education, social welfare and health, a slight increase from 35 percent over the period FY06-10. Education spending dominates with over half of this expenditure but all three saw significant increases in real terms over the last decade. Between FY06 and FY14, health spending increased by around 80 percent in real terms and education by around 66 percent. There was a clear re-prioritization toward social welfare, which more than tripled during the period. However, as with other non-interest recurrent expenditure, social sector spending growth slowed considerably after FY11, from an annual average of 13 percent before then to just 2 percent since.

Agriculture expenditure has seen an increase and evaluating the effectiveness of high expenditure in the area will be important. Agriculture expenditure more than tripled during the last decade to reach a fifth of non-interest recurrent expenditure. This was driven primarily by subsidies (including fertilizer and farm fuel), which increased eightfold over the period. At the same time, real agricultural output increased by 35 percent. Evaluating whether these subsidies, which are subject to world fuel prices, are achieving their aims will be important.

Insufficient resources to maintain public infrastructure?

While most areas of the recurrent budget saw real growth over the last decade, infrastructure expenditure stagnated, raising questions as to the sustainability of increased capital investments. Infrastructure (maintenance, rather than new investment, by and large) declined from 10 percent of non-interest recurrent expenditure to 6 percent in FY14. Despite an increase in public investment, infrastructure expenditure has hardly shifted in real terms over the past decade. This suggests that care should be taken when developing capital investment projects to ensure sufficient resources are available to maintain new infrastructure, rather than risking it fall into disrepair.

Allowances drive public sector remuneration and significant steps forward in solving the pension problem

Public sector remuneration has been driven by allowances, especially in years without pay increases. Between FY06 and FY14, remuneration expenditure increased by around 50 percent. Since this was lower than the overall non-interest recurrent increase, remuneration declined from 35 to 30 percent of the total. The increase was driven by allowances, which more than doubled during the period. Allowances appear to provide a means of increasing total remuneration during years without public sector pay increases. For example, spending on pay of officers and pay of establishment stagnated between FY06 and FY09. At the same time allowances increased by close to 50 percent but a pay increase at the beginning of FY10 boosted wages and resulted in a reduction in allowances.

Reforms significantly tamed booming pension expenditure though some challenges remain. After very fast expenditure growth between FY08 and FY11, the government enacted pension reforms in FY12. The retirement age for public sector employees was increased from 57 to 59 years of age. With an estimated 40,000 public servants retiring each year the impact was strong. Expenditure on pensions and gratuities fell from a peak of 9 percent of non-interest recurrent expenditures in FY11 to 6 percent in FY14. Expenditure fell in both real and nominal terms by around one third. However while these reforms helped to address challenges related to the Civil Servant Retirement Scheme, there remain challenges with the (unfunded) General Provident Fund (GPF). While the net inflows to the GPF are currently positive and partly used to finance the fiscal deficit, this risks turning negative in the future, presenting fiscal costs.

Growing development expenditure broadly aligned with development priorities

Development expenditures have grown significantly in importance over the last five years reaching over a third of total expenditure.⁴ This represents a considerable increase from 27 percent in FY10 and reflects a priority toward investment articulated in Bangladesh's development priorities.⁵ As with recurrent expenditure, investments related to social or human development dominate the Annual Development Plan (ADP) portfolio, accounting for around 20 percent of the FY15 budget. The share of the transport and communication sector increased from 17 percent in FY10 to 26 percent in FY15, also representing a development priority.

Overly ambitious development budgeting?

The number of projects in the development portfolio increased over the last five years but this has thinned out scarce financial and time resources, resulting in implementation delays. There is often a significant time lag between the time projects become part of the ADP and the time execution starts, and more than 80 percent of projects take more time to complete than envisaged at the time of planning. For example, during FY12, no expenditure at all had occurred on around 22 percent of the projects in the portfolio, though this has reduced since then. Finally, many projects suffer from significant cost overruns. The delays and the cost overruns result in lower economic and social returns to investment and a deferral of envisioned benefits further into the future. This issue has been persistent over time and has been eroding the efficiency of the investment portfolio.

⁴ Development expenditure was worth 33 percent of expenditure excluding net lending, and 40 percent of expenditure including net lending in FY14, much of which is investment funneled through SOEs. In both cases, it represents an increase of 7 percentage points since FY10.

⁵ As indicated by the Sixth Five Year Plan, and the Plan of Bangladesh 2010 to 2021: Making Vision 2021 a Reality. See: Planning Commission (2010, 2010b, 2012).

Significant revisions are systematically made to the ADP, suggesting poor development planning. The number of projects included in the Revised ADP (RADP) are systematically higher than the number in the ADP originally passed by Parliament. At the same time, budget allocations tend to be reduced. For example, in FY14, the RADP had about 20 percent more projects than the same year's ADP. On the other hand, allocations were reduced by over 4 percent.

Public investment management has limitations. A recent review of public investment management (PIM) suggests that fragmented institutional arrangements with limited coordination limit the government's ability to improve project selection, design, implementation and evaluation. The PIM regulatory framework consists of a diverse set of laws, ordinances, executive orders, some of which are inconsistent.

Steps forward from a reasonably solid base

While Bangladesh has much to be proud of in its sustainable budgeting and decent monitoring systems, steps can always be taken to improve. While this PER Update did not go into the level of depth – notably on a sectoral level or a public administration level – of the PER-2010, several findings do emerge from the analysis presented in this report, many of which overlap with the conclusions of the PER-2010. Broadly, the following areas emerge from the analysis presented in this Update for improvement:

- Further increasing revenue mobilization including by expanding the tax base, increasing the capacity of the NBR, using modern methods to encourage tax payments such as automation or insights from behavioral economics. (Also noted in PER-2010 as an issue.)
- Evaluating fiscal risks posed by contingent liabilities including through pensions (the GPF) and SOEs (including banks) and taking steps to mitigate these, where required. (Also noted in PER-2010 as an issue.)
- Reducing interest costs including by ensuring concessional foreign financing and selecting financing options that minimize interest on domestic debt. (Also noted in PER-2010 as an issue but the importance has become significantly more pronounced.)
- Reviewing the efficiency and equity of subsidies, including those targeted toward agriculture/fuel, and making adjustments if the aims are not being achieved efficiently. (Also noted in PER-2010 as an issue.)
- Improving budgeting accuracy of both the recurrent and development budgets including though some quick wins such as improved forecasting of pensions expenditures, and by working closely with line ministries to improve the realism of investment projects timetables. (Also noted in PER-2010 as an issue for the development budget and newly emerging for the recurrent budget.)
- Reconsidering remuneration mechanisms to make public sector salaries more predictable and less reliant on allowances. (Newly emerging issue.)
- Ensuring sufficient resources are available for maintaining existing and new infrastructure will be important in light of an expanding investment budget but stagnant maintenance budget. (Newly emerging issue though indicated in the PER-2010.)
- Restructuring the investment portfolio to ensure only viable projects, with acceptable economic or social rates of return are included. (Also noted in PER-2010 as an issue.)

The analysis presented in this report is based on headline, rather than detailed sectoral data, and a deeper analysis may be merited in some areas, including but not necessarily limited to:

- Revenues, including the tax system, policies and management;
- The cost of tax expenditures;
- Sustainability of the GPF (public servant pension system);
- Efficiency and equity of subsidies (either direct or through tax expenditure), including in agriculture, trade, energy and SOEs;
- Resource requirements for the maintenance of existing infrastructure and the link between public investment, total investment and the ADP;
- The extent to which interest payments crowd out other expenditure and potential solutions;
- Some specific sectors – such as health and energy – may benefit from deeper analysis to understand progress in recent years and the outstanding challenges.

1 AGGREGATE FISCAL PERFORMANCE^{6,7}

Bangladesh has a decent record in headline fiscal discipline. Budget deficits are among the lowest in the region, and resources are broadly focused on priority areas. Public debt is low and considered sustainable, even in the event of various shocks. However, Bangladesh stands out as having among the world's lowest revenue as a share of GDP. This limits resources available for important investment, social services and other areas. While a recent DSA shows that Bangladesh appears not to be at risk of debt distress over the medium- to long-term, this assumes real economic growth sustained at 6.5 to 7 percent every year for the next 20 years and contained fiscal deficits. Under less optimistic scenarios there remain some pockets of vulnerability. Notably, contingent liabilities risk putting some pressure on the fiscal stance, particularly those from SOEs.

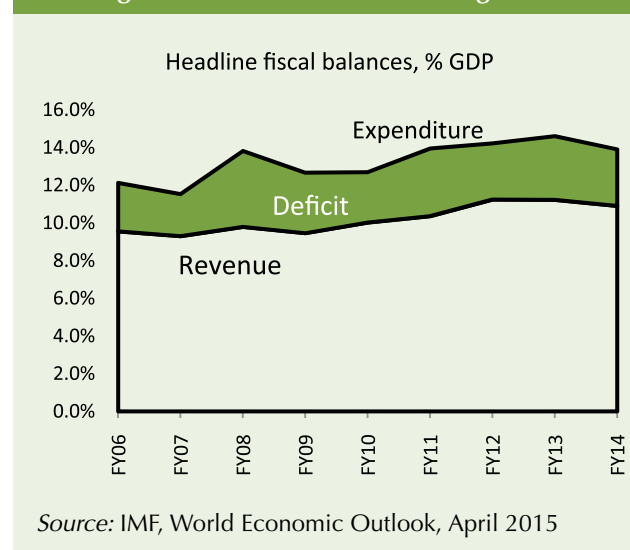
Many of the findings from the PER-2010 remain relevant including: (i) the need to mobilize more revenue; (ii) the need to evaluate the risks posed by contingent liabilities including pensions and from SOEs; and (iii) the need to ensure access to concessional financing and to ensure interest rates are as low as possible.

1.1 Macro-fiscal outcomes

1.1. **Over the past five years the Government of Bangladesh maintained its track record of generally prudent fiscal management.** The fiscal deficit run by the government has generally been within manageable limits during this period (Figure 1.1). In FY14, at 3 percent of GDP, Bangladesh's fiscal deficit was much lower than the average for the South Asia region (Table 1.1). However, when reviewing the government's overall performance in maintaining aggregate fiscal discipline over this period, several important caveats should also be borne in mind:

- Despite having increased more than 2 percentage points of GDP in the last 5 years, total public expenditures in Bangladesh are among the lowest in the world by some measures, with low revenues and contained expenditures limiting resources available for needed investment in and maintenance of infrastructure, as well as social expenditures.
- Bangladesh's public sector operations, including those of several fairly large state-owned enterprises (SOEs) are at times not fully reflected in these fiscal accounts.

Figure 1.1. Prudent fiscal management



⁶ Chapter prepared by Simon Davies, Nadeem Rizwan, Adiba Sanjana, and Muhammad Waheed.

⁷ The team is grateful to the Ministry of Finance and Ministry of Planning for providing much of data used throughout this report. In addition, the team drew on reports prepared by the Ministry of Finance (2012 and 2013).

- While the record in fiscal discipline has been commendable, it stems partly from a lack of capacity among some ministries to spend allocated (development budget) resources.
- Finally, it should be noted, that this is an Update to the PER-2010. As such, it does not go into the depth of standard PERs. Therefore, it draws relevant conclusions based on the analysis presented but also notes where more in-depth analysis could be undertaken to confirm the results or to gain a better understanding of the reasons behind the conclusions.

1.2. Sustained economic growth meant public spending increased by 8 percent per year in real terms between FY09 and FY14. Between 2009 and 2014, GDP growth in Bangladesh averaged 6.2 percent per year, and per capita gross national income (GNI) rose from \$843 in 2009-10 to an estimated \$1,190 in 2013-14. Combined with the impact of increased total government spending as a share of GDP, public expenditures per capita increased from \$86 in FY09 to \$104 in FY14.

Table 1.1. Fiscal trends compare well with other countries in the region

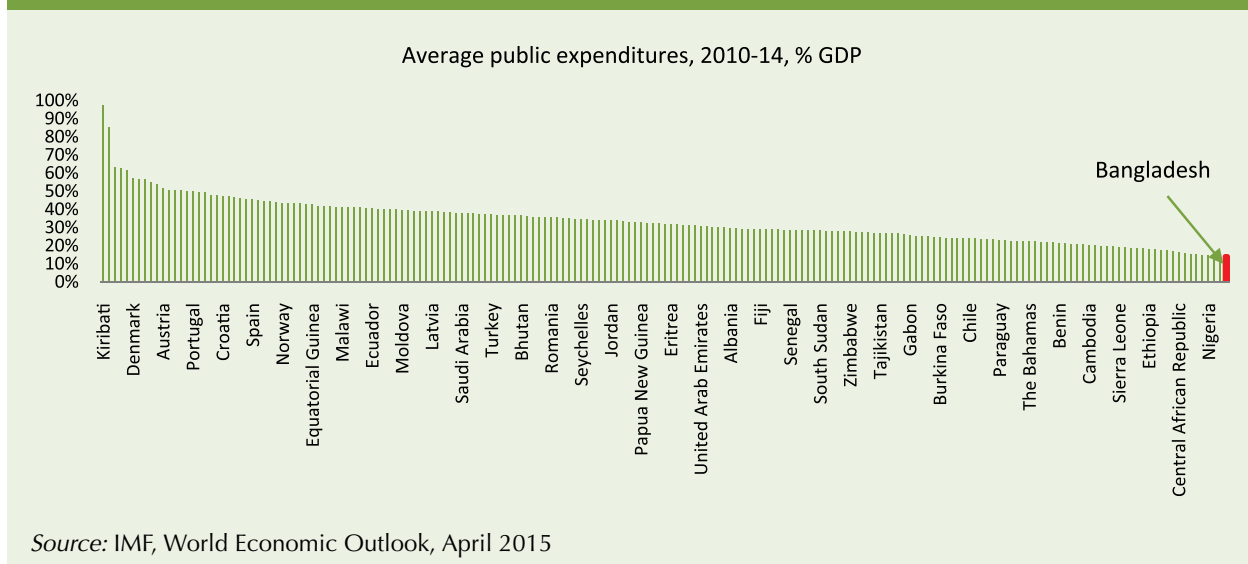
Indicator (% GDP)	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	South Asia 2014
General government revenue	9.6%	9.3%	9.8%	9.5%	10.0%	10.4%	11.2%	11.2%	10.9%	17.5%
General government expenditure	12.1%	11.5%	13.8%	12.7%	12.7%	14.0%	14.2%	14.6%	13.9%	21.3%
Overall budget deficit	-2.6%	-2.2%	-4.0%	-3.2%	-2.7%	-3.6%	-3.0%	-3.4%	-3.0%	-3.7%
Primary deficit	-1.0%	-0.6%	-1.9%	-1.0%	-0.8%	-1.9%	-1.1%	-1.4%	-0.9%	-0.7%
General government gross debt	42.3%	41.9%	40.6%	39.5%	36.6%	35.3%	33.8%	34.7%	33.9%	62.1%

1.3. A burst of reasonably decent revenue performance over FY10-FY12 has since tapered off and Bangladesh now has among the lowest public sector revenues in the world. Averaging less than 11 percent of GDP over the period 2010-14, no country has lower public sector revenues as a share of GDP than Bangladesh (Figure 1.2). Unsurprisingly, with fairly low fiscal deficits, this results in correspondingly low public expenditure (Figure 1.3).

Figure 1.2. Bangladesh has among the lowest public sector revenue in the world...



Figure 1.3. ... and among the lowest public expenditure



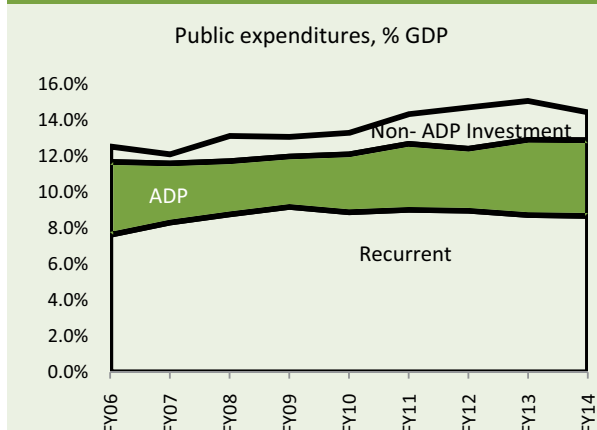
1.2 Allocation of fiscal resources: Recurrent versus investment

1.4. **With revenue growing slowly, the government was able to increase both recurrent and investment expenditures.** Public expenditure grew at an annual average of 8 percent per year in real terms between FY10 and FY14. While both recurrent and investment expenditures saw significant increases, the priority was clearly focused toward increased investment. Public investment grew at an annual average of 14 percent in real terms over the period, while recurrent expenditure increased by an annual average of 6 percent. Investment expenditures increased as a share of total expenditures from 33 to 40 percent (Figure 1.4).

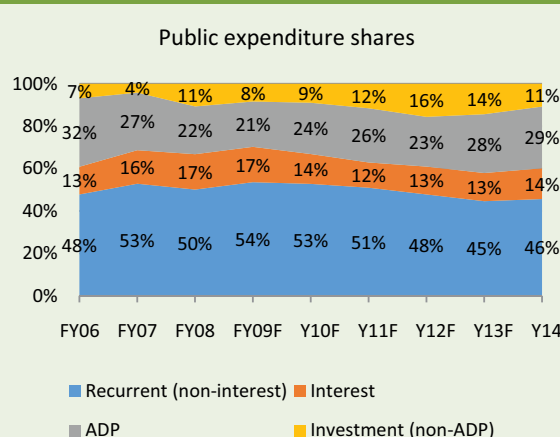
1.5. **Around a quarter of recurrent expenditure is taken up by interest payments.** Since FY11, interest payments have become an increasingly important part of the recurrent budget, rising from a decade-low of 19 percent of total recurrent expenditure in FY11 to 24 percent in FY14. There is some evidence that they have crowded out other expenditures. The top spending sectors are education (which absorbs around a fifth of non-interest recurrent expenditures), agriculture (also a fifth), social welfare (10 percent), and general administration and security (around 30 percent). Agriculture and social welfare have seen increases over the past decade, partially reflecting the government's priorities for social sectors.

1.6. **Public investment is undertaken through two parallel streams —the Annual Development Plan (ADP) and non-Annual Development Plan (non-ADP).** Most public investments are financed through the ADP. However, an increasing proportion of public investment is being financed outside the ADP (Figure 1.5). The share of public investment through non-ADP segment has increased steadily during recent years. Much of it is captured through “net lending” to State-Owned Enterprises (SOEs). In practice, both, ADP and Non-ADP segments contain elements of recurrent and capital spending.⁸ Although this practice may provide flexibility to government, this creates fragmentation and poses questions for the planning and execution efficiency. The sectors that benefit from the largest shares of the ADP budget are transport and communications, energy, and social development, with transport becoming particularly important in recent years, absorbing around a quarter of ADP.

⁸ See World Bank (2010).

Figure 1.4. Expenditures increased in line with revenues...

Source: BBS and WBG staff estimates

Figure 1.5. ... and investment grew as a share of total public expenditure

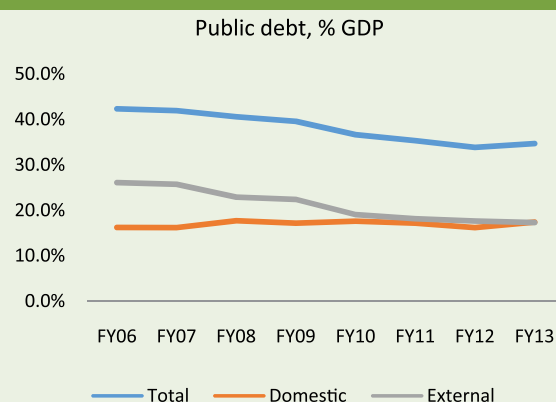
Source: MoF, MoP, BBS and WBG staff estimates

1.3 Public debt performance

1.7. **Public debt has fallen over the last five years, driven by declining external debt.** Helped partly by a strong growth performance (Figure 1.6) Bangladesh's external debt has fallen steadily by about 1 percentage point of GDP per year, reaching less than 34 percent of GDP at the end of FY14 (Figure 1.7). A rise in the domestic financed component of the deficit has resulted in higher domestic debt as a share of government debt stock. Net foreign financing of the deficit declined significantly from around 4.8 percent of GDP in the 1990s to well under 2 percent of GDP in recent years; by contrast, net domestic financing increased from around 1.6 percent of GDP in 2000 to 3.3 percent in FY13. This explains the recent rise in the share of interest in total recurrent expenditure, and suggests it would be worth understanding whether cheaper financing options may be available. Consequently, total external debt fell considerably as a share of GDP. Nearly the entire decrease in outstanding government debt stock since 2009 was attributable to a decline in external debt, as domestic debt as a share of GDP remained fairly stable at around 17 percent of GDP. The decline was especially pronounced since FY09, when total debt as a share of GDP fell by nearly 6 percentage points, with almost all of this decline coming from declining external debt.

Figure 1.6. Strong growth performance...

Source: BBS and WBG staff estimates

Figure 1.7. ... and declining public debt, especially external debt

Source: IMF, World Economic Outlook, April 2015

1.8. **The latest Debt Sustainability Analysis (DSA) revealed that Bangladesh is at low risk of external or domestic debt distress but this assumes a fairly optimistic baseline.** A DSA was conducted by the IMF and IDA teams in May 2014.⁹ Assuming that public debt continues its downward trend as a share of GDP, the DSA found that under the standard shocks, Bangladeshi public debt remained within acceptable limits in terms of GDP, revenues and exports over the medium to long term.¹⁰ However, this assumes a baseline that could be considered optimistic, including real economic growth of 6-7 percent each year for the next 20 years and well-contained fiscal deficits (as well as inflation of 4-5 percent each year).

1.9. **Bangladesh-specific “worst case scenarios” (under the same optimistic baseline) shows there is no room for complacency.** The DSA update tested a case with a combination of shocks to the baseline: (i) the issuance of a 10-year bond worth 0.6 percent of GDP in FY15; (ii) non-concessional borrowing of 2.3 percent of GDP in FY19 to finance construction of power plants; and (iii) the recapitalization of state-owned banks to the tune of 1.3 percent of GDP in FY15. The results concluded: “[u]nder this alternative scenario, no policy-dependent sustainability thresholds are breached even when key variables are subjected to standard bound tests. Thus, the risk of external debt distress remains low also in the alternative scenario. Similarly, the PV of public debt remains below the respective solvency and liquidity thresholds”.¹¹ Despite this, caution should be exercised, particularly in light of the low revenue, and the risk that interest payments may crowd out other essential expenditure. In addition, an alternative scenario taking into account the consequences of failing to introduce the new VAT with no consolidation in expenditure shows that the fiscal deficit would widen, leading to higher domestic borrowing costs. As a result, there would be a significant deterioration in all standard debt sustainability indicators, and the debt trajectory would become less sustainable. This implies that in the absence of a boost to tax revenues through the implementation of the new VAT law or other means, to keep public debt on a sustainable path, a significant cut in public expenditure would be needed, with potential consequences for economic growth and poverty reduction.

1.4 Fiscal risks¹²

1.10. **A recent assessment of fiscal risks in Bangladesh suggests that the fiscal stance may be vulnerable in the short term to a number of shocks outside the control of the government.** The assessment finds that fiscal sustainability may be threatened in particular by increasing international fuel prices and exchange rate depreciation, with increased domestic interest rates also having an effect. With direct energy subsidies estimated at 0.6 percent of GDP in FY14 and 0.5 percent in FY16, and fertilizer subsidies worth close to 1 percent of GDP (see recurrent expenditure chapter), increases in the international price of oil and urea¹³, whose price tends to track that of oil, would have a significant impact on fiscal balances. An increase in the price of oil and urea of around 30 percent is estimated to increase the deficit by around 0.6 percent of GDP on average over a five year period and lead to a cumulative increase in the debt stock by around

⁹ See IMF (2014).

¹⁰ Standard shocks include: (i) a two year reduction in economic growth by one standard deviation based on historical performance; (ii) a two year reduction in export value growth by one standard deviation based on historical performance; (iii) a two year reduction in inflation by one standard deviation based on historical performance; and (iv) a permanent 30 percent nominal exchange rate depreciation, as well as combinations of these scenarios.

¹¹ Ibid.

¹² This section is based on findings in Medina, 2015. Assessing Fiscal Risks in Bangladesh. IMF Working Paper WP/15/110.

¹³ An organic compound commonly used in fertilizer.

3 percent of GDP over the period.¹⁴ Similarly, a permanent 10 percent depreciation in the Taka/US\$ exchange rate would increase the fiscal deficit by around 0.8 percent of GDP and increase the stock of debt by over 6 percent of GDP over five years. An increase in domestic interest rates by around 130 basis points is estimated to increase the fiscal deficit by around 0.3 percent of GDP and increase public debt by 1.3 percent of GDP over five years. A combination of these, or other risks discussed below, occurring around the same time could be particularly problematic, especially in the event that the government is unable to issue sufficient debt to finance costs.

1.11. Loan guarantees also pose a risk for fiscal sustainability. Until FY12, guarantees tended to be small and related to agricultural credit. However, after FY12, there was a steep increase in guarantees, primarily provided to state-owned commercial banks (SOCB) for lending to non-financial SOEs. The stock of government guaranteed debt rose from 3.5 percent of GDP in FY14 to over 5 percent by end-FY13, of which guarantees to SOCBs represented 30 percent of the total. Guarantees have since declined to 3.9 percent of GDP in FY15, due largely to a decline in guarantees to the energy sector by around 20 percent thanks to reduced global oil prices. Other state-owned banks (SOB) also have balance sheet weaknesses, with capital shortfalls compared to the regulatory minimum estimate at around 2.5 percent of GDP at end-2013.

1.12. And, despite significant recent efforts, contingent liabilities related to pensions also present risks. The Civil Servant Retirement Scheme (CSRS), the public sector pension scheme, poses fiscal risks. With around 1.2 million public servants, of whom up to 40,000 retire each year, pension expenditure is high. It is likely to rise as demographic trends drive up the number of retirees each year. As discussed in the Recurrent Expenditure chapter, some progress appears to have been made in addressing the issues related to CSRS. The General Provident Fund (GPF) is a mandatory defined contribution scheme for civil servants. Accounts accrue interest at around 12 percent per year and retiring civil servants can withdraw their full account balance. In addition civil servants can borrow up to 80 percent of their contributions at any time. The total stock of contributions and interest amounted to around 2 percent of GDP at end-2013. However, the GPF is unfunded and the cash flows (which are currently strongly net positive) are used partly to finance the deficit. While this may be helpful for civil servants, as the number of retirees increases, meeting the cost of withdrawals may prove to be a fiscal burden.

1.13. Recent recurring unrest may have an impact on the economy and therefore on fiscal performance. The recent World Bank Bangladesh Development Update¹⁵ notes that the unrest may disrupt transport and therefore supply chains. It could also discourage investment. Even the fairly resilient garment sector appears to have suffered and, in total, direct production losses from the recent turmoil may reach 1 percent of GDP. Given the link between GDP growth and tax revenue, if the turmoil continues for a long period and firms are unable to make up for loss orders, tax revenues may be impacted.

1.5 Conclusions and recommendations

1.14. Bangladesh has shown a commendable record in maintaining fiscal discipline. In line with the findings in the PER-2010, this PER Update finds that prudent fiscal policies have kept the fiscal deficit and debt indicators under control, despite numerous pressures placed on scarce public resources due to recurring natural disasters and unpredictably changing global prices on food, fuel and fertilizer. The central government's fiscal stance is sustainable at the current and projected levels of the fiscal deficit.

¹⁴ Compared to the baseline projections used.

¹⁵ See: World Bank. 2015b. Bangladesh Development Update. Dhaka: The World Bank.

1.15. **However, there remain risks, particularly when considering contingent liabilities.** Risks relate to SOEs and state-owned commercial banks in particular. Calls on guarantees by these may prove costly. In addition, although considerable strides have been taken, there remain some fiscal risks associated with public sector pensions. These risks could be particularly large if several calls on guarantees or other risks materialize at the same time and the government is not able to issue sufficient debt to cover the payments. Fiscal sustainability is highly dependent on the performance of economic growth and concessional foreign financing, which helps to keep interest rates low. Maintaining current rates of economic growth and mobilizing concessional foreign financing remain critical in avoiding any major fiscal adjustments to maintain sustainability.

1.16. **This analysis does not go into the same depth as the PER-2010 in terms of sectoral analyses but the key recommendations emerging from this analysis are broadly in line with the findings in the PER-2010:**

- *Increasing revenue mobilization further is especially important as this would provide a buffer to adverse fiscal conditions.* At 10-11 percent of GDP, Bangladesh has the lowest tax-to-GDP ratio in the world. The gradual reforms that have been attempted over the last 6-7 years have not produced sustained results and a comprehensive strategy that envisages an overhaul of the current system is needed. There is a case for increasing the domestic tax-to-GDP ratio through broadening the tax base and improving revenue management, in particular VAT and income tax. Implementing the recent VAT reforms will be an important step. Finally, improving revenue administration to increase voluntary compliance by taxpayers should accompany tax policy reforms.
- *Evaluating remaining risks posed by the GPF and taking action to mitigate them would help to prevent this becoming a fiscal burden.* With an increasing number of retirees, the GPF may turn from a means of financing the deficit into a burden. Estimating future flows to ensure that costs can be met over a number of years rather than become a negative shock would help to ensure fiscal sustainability.
- *Ensuring concessional foreign financing and ensuring interest rates are as low as possible would make increased resources available for other key areas.* Although Bangladesh has sustainable debt, limited domestic resources mean that it would be helpful to contain interest expenditures to ensure sufficient resources are available for needed investment and recurrent expenditures.

2 REVENUE¹⁶

Bangladesh has among the lowest revenue as a share of GDP in the world. Success in boosting revenues between FY10 and FY12 has tapered off and revenue as a share of GDP declined somewhat between FY12 and FY14. Bangladesh has the lowest “tax effort” – actual revenues compared to potential collections, given the country’s characteristics – in the region. In addition, its tax revenues are lower than would be expected for a country of its level of development. However, there have been improvements in recent years: a dependency on border taxes has declined slowly and several reforms, including automation, are underway, and a new, simplified VAT law should come into force during 2016. Other avenues to boost revenue collection through broadening tax base and improving efficiency need attention.

2.1 Overall revenue performance

2.1. Revenue mobilization in Bangladesh is low. During the last ten years, revenue averaged 9.8 percent of GDP. The revenue to GDP ratio increased somewhat between FY10 and FY12 but this trend has reversed since then (Figure 2.1), and it was 10.4 percent in FY14, the lowest in South and East Asia, and, indeed, among the lowest in the world (Figure 2.2). The low level of revenue collection results in fewer available resources for critical infrastructure and social sector requirements than other countries at similar level of development, despite significant infrastructure needs and pervasive poverty. This places Bangladesh at a distinct disadvantage over the long term in being able to reduce poverty and propel the country to middle income status by 2021, as envisioned in the country’s long term development strategy.

Figure 2.1. Revenue has increased as a share of GDP over the last decade...

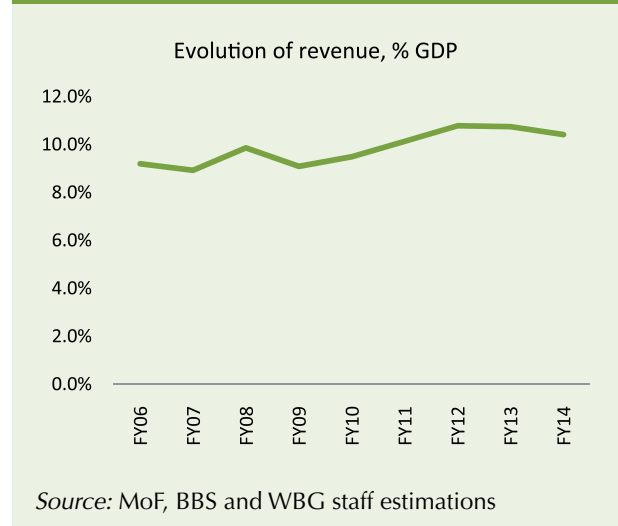
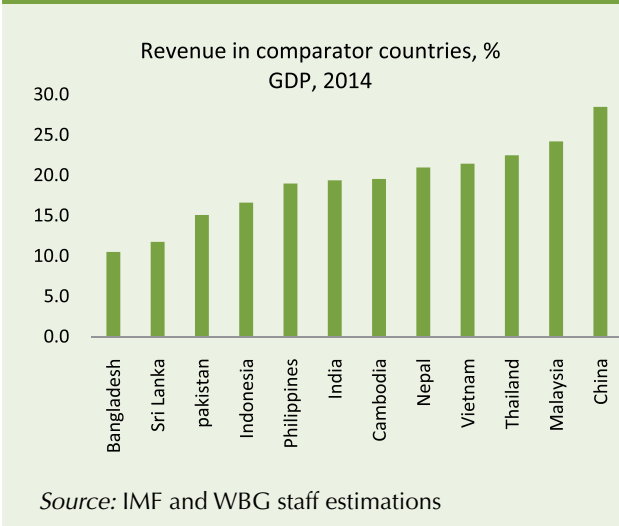


Figure 2.2. ... but remains lower than other countries in the region and, indeed, the world



¹⁶ Chapter prepared by Nadeem Rizwan.

2.2. Growing revenue collections during FY10-12 boosted the elasticity of tax revenue to growth but there are reasons to remain cautious. During the period 2008-13, every one percent of growth brought an increase in revenue of 1.4 percent (Table 2.1). This compares favorably with previous periods and reflects an increase in revenue as a share of GDP. However, this increase came largely thanks to a few well-performing years and the response of tax revenue to GDP growth has slowed since FY12 (Figure 2.3). This may be related to a slow-down in tax policy and administrative reforms. In addition, customs revenue (which includes all revenues collected at the border, including VAT), had a revenue elasticity of less than one. These “border revenues” make up over a quarter of total revenue, underscoring the importance of continuing the success in domestic revenue collection mobilization indicated by elasticities of 2.3 percent of income taxes and 1.5 for (domestic) VAT.

Table 2.1. Tax Revenue Elasticity in Bangladesh

Component	1990s	2000-07	2008-13
Total Tax Revenue (TR)	1.2	1.1	1.4
Income Tax Revenue (ITR)	1.1	1.6	2.3
VAT (VTR)	1.4	1.9	1.5
Customs Revenue (CTR)	1.2	0.8	0.4

Source: NBR, BBS, and WB staff estimates.
Note: VAT = Domestic VAT; Customs Revenue = Rev from CD, SD, VAT on imports.

2.3. Tax revenue is lower than expected for Bangladesh’s level of development. Despite the increase over FY10-12, tax revenue remained significantly below other countries of a similar level of development in 2013 (Figure 2.4). The existing tax system appears to find it difficult to bring new income generating activities under the tax net, unlike other low and lower middle income countries. Ways to boost tax revenue may include: (i) increasing the efficiency of the tax administration; (ii) broadening the tax base; (iii) simplifying and increasing the transparency of the tax system; and (iv) reducing corruption and tax evasion.¹⁷

Figure 2.3. In recent years, tax revenue increases at a similar rate to nominal economic growth...

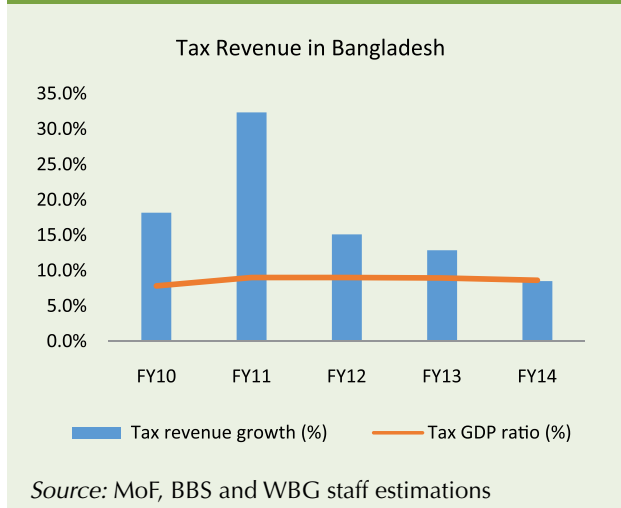
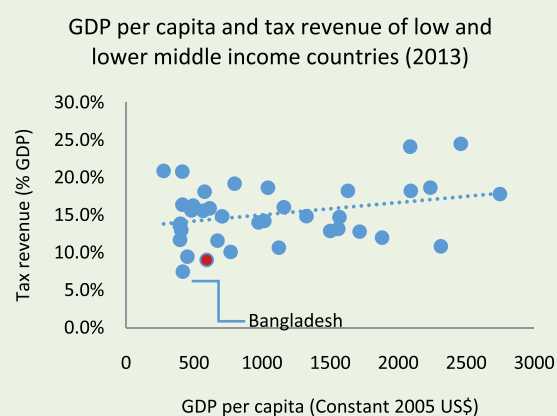


Figure 2.4. ...and tax revenue is lower than expected for Bangladesh’s level of development



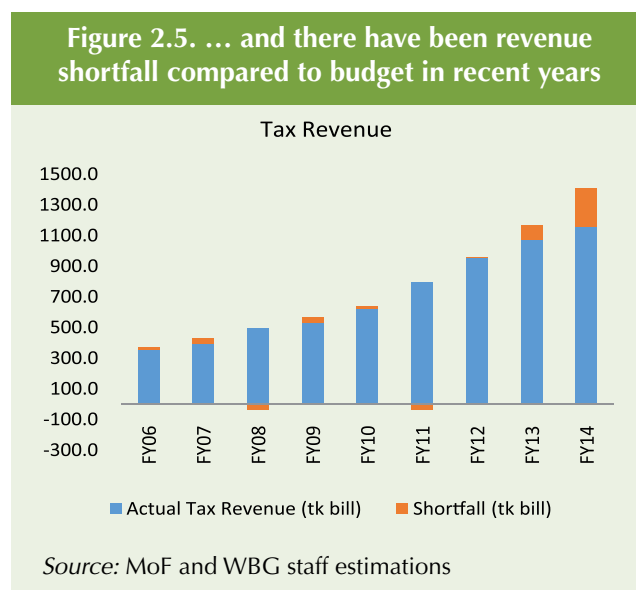
¹⁷ Project Appraisal Document, VAT Improvement Program (VIP), April 15, 2014.

2.4. **Cross-country evidence reveals that Bangladesh's tax effort is also low.**¹⁸ A cross country benchmarking exercise showed that Bangladesh's tax revenue efforts are the lowest among comparator countries in South and East Asia (Table 2.2). This suggests tax collections are below its potential taxable capacity, given its economic, social and institutional characteristics. Moreover, the tax revenue effort has remained stagnant over the years, resulting in tax revenues consistently falling short of the budget target (Figure 2.5).

Table 2.2. Taxes are significantly below potential in Bangladesh...			
Average Trends in Tax Effort			
	1994-2004	2004-2012	1994-2012
Bangladesh	0.67	0.64	0.65
Cambodia	1.02	1.14	1.12
India	1.16	1.15	1.16
Indonesia	0.96	0.76	0.86
Malaysia	0.55	0.62	1.08
Sri Lanka	1.15	0.8	0.98
Thailand	0.94	1.08	1.01
Vietnam	1.56	1.72	1.58

Source: Bayraktar, Le and Moreno-Dodson (2014) in World Bank. 2015c

Note: An elasticity of greater than one indicates that revenues increase at a faster rate than GDP. Alternatively put, revenue growth is faster than economic growth. This is clearly not sustainable ad infinitum.



2.2 Revenue structure

2.5. **Most revenue comes from taxes.** Around 96 percent of the tax revenue is collected by the NBR¹⁹ through income tax, VAT and various trade taxes (Figure 2.6 and Box 1). Tax revenue was around 82 percent of the total revenue in FY14 while the rest was non-tax revenue. Major items in the non-tax revenue includes dividends and profits, administrative fees and other non-tax revenues (for example, spectrum fees collected from telecom operators).

2.6. **The corporate tax rate is high in Bangladesh compared to South and East Asian counterparts.** Although personal income tax is in line with peer countries, the corporate income tax is high compared to international standards (Table 2.3). At present, publicly traded companies are subject to a rate of 25 percent, while non-publicly traded companies face a rate of 35 percent. Publicly and non-publicly traded banks, insurance companies and other financial institutions face a rate of 40 percent and 42.5

¹⁸ Tax effort is defined as an index of the ratio between the share of the actual tax collection in gross domestic product and taxable capacity and Taxable capacity refers to the predicted tax-to-gross domestic product ratio that can be estimated empirically, taking into account a country's specific macroeconomic, demographic, and institutional features. See Khwaja and Iyer (2014), Bayraktar, Le and Moreno-Dodson (2012).

¹⁹ The National Board of Revenue (NBR), which falls under the Ministry of Finance has the primary responsibility of collecting revenue.

percent respectively. Cigarette manufacturers and non-publicly traded telecom operators face the highest rate of 45 percent. The VAT rate of 15 percent is not uniform, though under the new VAT law, government plans to enforce a single VAT rate starting from July 2016. There is a general perception in Bangladesh, reportedly shared even by some think tanks, that the 15 percent rate is too high by international standards.

Figure 2.6. Domestic tax collections have become more important but there remains a strong reliance on border revenues...

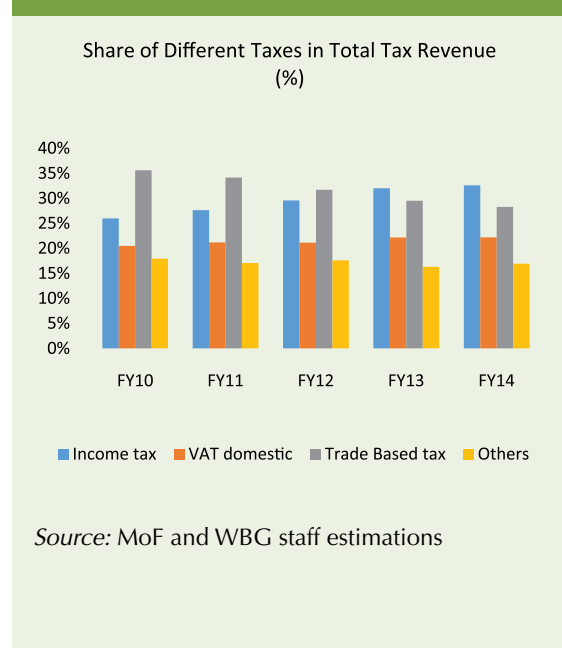


Table 2.3. ... and some domestic tax rates are high compared with other countries in South and East Asia

	Individual Income tax	Corporate tax	VAT
South Asia			
Bangladesh	30	25-45*	15
Sri Lanka	24	28	12
India	34	35	12 to 15**
Pakistan	20***	33	17
East Asia			
China	45	25	17
Indonesia	30	25	10
Thailand	35	20	7
Philippine	32	30	12
Malaysia	25	25	6
Vietnam	35	22	10

Source: KPMG and www.vatlive.com retrieved on May 28, 2015

Notes: * 25 percent for publicly traded company other than telecom operators and cigarette manufacturers, ** Depending on state, *** Rate in 2013

2.7. Recent changes in the revenue structure have been encouraging. There has been a slow shift in revenue composition, with a reduced dependency on trade based taxes in favor of domestic taxation. The share of import-based taxes in total tax revenue fell from 36 percent in FY10 to 28 percent in FY14. In contrast, the share of domestic-based taxes in NBR revenue increased from 64 percent in FY10 to 72 percent in FY14. Within domestic-based taxes, income tax revenue increased more than the share of domestic VAT, with the shares standing at 33 percent and 22 percent in FY14, respectively. The shift in the composition of VAT revenue from import-based VAT to domestic VAT indicates that domestic consumption has been tilting toward domestic production.

2.8. Revenue mobilization efforts are underway. There are roughly 1.8 million registered tax payers in Bangladesh, of whom around 1.2 million – or less than 1.2 percent of the population above the \$1.25 a day poverty line – pay regular taxes. Broadening the tax base and strengthening tax administration would improve revenue collection. In order to widen the tax net, and create a more efficient, transparent and comprehensive tax collection system, the government has introduced some tax mobilization schemes. For example, the NBR developed a comprehensive Tax Modernization Plan (2011-2016) designed to address tax policy reform and administration issues.²⁰ A new VAT law was passed by the Parliament in

²⁰ See National Board of Revenue (2010).

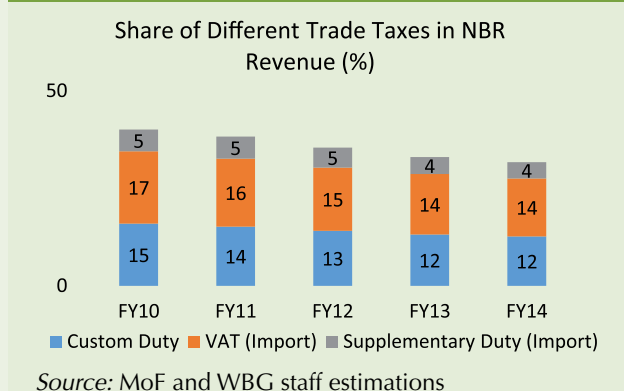
November 2012. The new law simplifies the VAT regime with fewer exemptions, a unified VAT rate, and a VAT automation processes. The new law is supposed to be implemented starting from July 2016. The government has also started or in the middle of various other reforms including the process of automation of income tax procedure, revision of customs act, implementation of Automated System for Customs Data (ASYCUDA) World and strengthening human resources of the NBR.

Box 1. Trade Taxes in Bangladesh

Trade taxes in Bangladesh are heavily influenced by considerations of revenue and assistance to local industries rather than considerations of economic growth or trade policy. The National Board of Revenue (NBR), which does not have export promotion as its policy goal, seems to have the final authority on tariff setting. While the average customs duty (CD) has come down over the past decade from 71 percent in FY92 to 13 percent in FY15, a proliferation of para-tariffs has resulted in a complex import tax regime and substantially increased the rate of border protection. These para-tariffs include regulatory duty (RD), supplementary duty (SD), as well as VAT paid at the border and are often not trade neutral. Tariffs are generally adjusted once a year as a part of the budget process. Pre-budget consultations with the business community and other stakeholders are held. The use of statutory regulatory orders (SROs) to announce post budget tariff or procedural changes creates unpredictability in business environment. However, the consolidation of valid SROs and making them available in the public domain has helped make the process more transparent.

Although Bangladesh's reliance on trade taxes has decreased somewhat, it is still quite high as more than a quarter (29 percent) of NBR revenue came from trade based taxes in FY14. The main sources of trade taxes are the CD and VAT on imports. Since FY10, the share of CD and import-VAT in NBR revenue decreased steadily (Figure 2.7). From FY10 to FY14, the combined share of CD and VAT in NBR revenue declined from one third to a quarter. Import-VAT holds the highest share of NBR revenue among trade related taxes with 14 percent of NBR revenue coming from it in FY14. In fact, import-VAT was the third highest source of NBR revenue in FY14, with income tax being the leading source (40 percent) followed by domestic VAT (23 percent).

Figure 2.7. Bangladesh relies strongly on taxes collected at the border but these collections are in decline



There are a large number of exemptions in the tariff schedule which benefit specific industries, single companies, and sometimes are under nontransparent "special order" labels. An analysis of customs transaction data at the tariff line level by the World Bank showed that exemptions figure in almost 30 percent of the total number of transactions and 44 percent of total trade value. These exemptions add up to a significant revenue shortfall. Overall, tax expenditures in Bangladesh appear to be very high. The last analysis undertaken (by the Bangladesh Bank in 2008) estimated that tax expenditures totaled around 2.5 percent of GDP.

Revenue goals are achievable with more trade-neutral border taxation. A less distortionary tax structure could achieve the same or even higher level of revenues. Removing exemptions may increase fiscal revenues significantly. Simulation results using the World Bank's Tariff Reform Impact Simulation Tool (TRIST) indicate that removing tariff exemptions would increase revenues by about 7–9 percent (while reducing imports by around 1 percent), and help compensate for the reduction or removal of others taxes while inducing more economic efficiency. Another simulation removing SDs and adopting a uniform rate of 15 percent for CD+RD found that tax revenues would increase by 0.9 percent, which illustrates the efficiency and revenue potential of simple and uniform taxation.

Source: Towards New Sources of Competitiveness in Bangladesh: A Bangladesh Diagnostic Trade Integration Study, The World Bank, 2015.

2.3 Conclusions and recommendations

2.9. **Bangladesh collects less revenue as a share of GDP than other countries in South Asia, and, indeed, the world, placing severe restrictions on resources available for the public sector.** With less than 11 percent of GDP raised in revenue, Bangladesh has limited resources to finance much-needed public investment, maintenance and social programs. This is despite the fact that its poverty rate and investment needs would require significant resources to tackle.

2.10. **There is a strong reliance on revenues collected at the border but this reliance is falling.** In FY10, 37 percent of tax revenues were collected at the border in the form of trade taxes, VAT and customs duty. This fell to 28 percent in FY14. However, border taxes appear to be determined in a non-transparent and unpredictable way, creating potentially negative economic consequences.

2.11. **It is clear that Bangladesh needs to raise additional public sector revenue. Despite not going into the same depth as the PER-2010 the analysis provided in this Update indicate several areas where reforms or deeper analysis could be undertaken:**

- *Finding ways to boost further domestic revenue collections or shore up existing border collections would help to compensate for or moderate declining border revenues. As world trade becomes freer, the imperative to achieve this will become stronger.*
- *Expanding the tax base, particularly by ensuring that it is expanded to new growth parts of the economy, will be important. Care will need to be taken to ensure that growth areas are not stifled by unsustainable taxes but sharing the tax burden and creating a level playing field for all areas of the economy could help to boost economic performance by reducing distortions.*
- *Reducing tax expenditures by phasing out ad hoc and arbitrary tax holidays, exemptions, rebates and such other tax concessions.*
- *Using modern methods to encourage tax payments could help to boost revenues without the need for legal or policy changes. Examples include: (i) simplifying and streamlining tax payment procedures; (ii) digitizing tax records; (iii) automating tax payments (which has already begun); and (iv) using insights from behavioral economics (which has already shown some promise in Bangladesh).*
- *Finding ways to increase the capacity and efficiency of the NBR as well as reducing corruption could help to increase tax payments. Such administrative improvements could help reduce evasion and losses due to corruption, as well as encourage compliance.*

3 RECURRENT EXPENDITURE²¹

Recurrent expenditure accounts for around two thirds of the budget (excluding net lending) and has seen fast annual growth over the last decade, in line with the additional resources generated from economic growth. However, during the second half of the decade, interest expenditures increased faster than other recurrent expenditures, and the former may have crowded out the latter to some extent, despite well-contained debt. As noted in the PER-2010, resource allocation is broadly aligned with government priorities of improving social services and advancing toward high HDI status by 2021. An increasing share of resources have been allocated toward social sectors and agriculture over the past decade, partially aligned with the government's development priorities. The PER-2010 found a declining share of resources going toward investment – largely maintenance of existing infrastructure. This trend has continued with investment expenditure stagnant in real terms over the last decade.

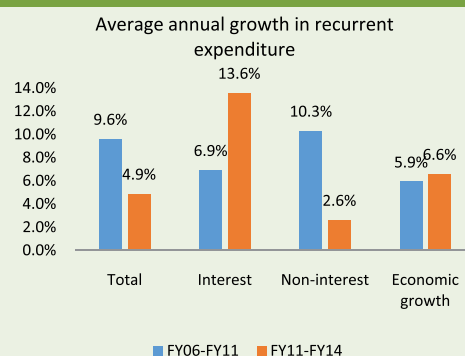
Many of the findings of the PER-2010 remain relevant, including: (i) the need to review the efficiency of subsidies; and (ii) ensuring that sufficient resources are made available to maintain existing infrastructure. Significant progress has been made on one issue: previously fast-increasing pension expenditures appear to have been contained. Some new issues have also emerged or grown in importance, including: (i) the need to contain interest expenditure; (ii) improving recurrent budgeting accuracy, potentially beginning with some “quick wins”; and (iii) reconsidering public sector remuneration modalities away from allowances and toward wages/salaries.

3.1 Overall recurrent expenditure performance

3.1. **Recurrent expenditure – such as teachers' salaries, medicines and social benefits – makes up the majority of public expenditure and total recurrent nearly doubled during the past decade.** Recurrent expenditure averaged around 71 percent of total public expenditures between FY06 and FY14²² or 8.7 percent of GDP. Between FY06 and FY14, recurrent expenditure increased by around 83 percent in real terms, or an annual average growth of 7.8 percent. This reflected fast economic growth, which provided for more public resources. During the same period, economic growth averaged 6.2 percent per year²³ and total GDP increased by 61 percent.

3.2. **However, recurrent expenditure performance during the last decade falls into two distinct periods, distinguished partly by the need to meet debt interest obligations.** Between FY06 and FY11, recurrent expenditure grew by an annual average of 10 percent but this fell to 5 percent over FY11 to FY14 (Figure 3.1). This was despite a slightly faster rate of economic growth (5.9 percent versus 6.6 percent). Interest payments grew faster in the second period, at 14 percent per year compared to 7 percent. At the same time, non-interest expenditure growth slowed considerably, from 10 percent between FY06 and FY11 to less than 3 percent between FY11 and FY14.

Figure 3.1. Two distinct periods in recurrent expenditure performance



Source: MoF and WBG staff estimations

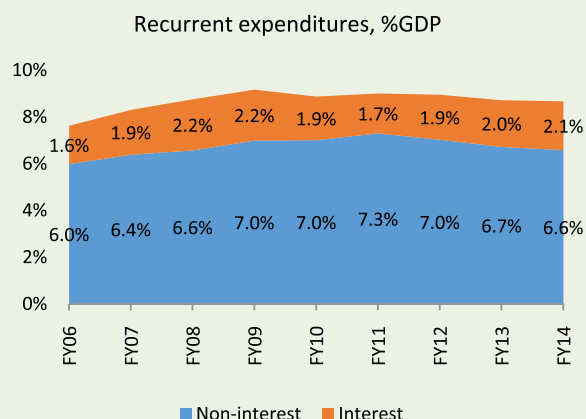
²¹ Chapter prepared by Simon Davies.

²² Excluding net lending, or 64 percent including net lending.

²³ 6.2 percent is the compound average annual growth rate.

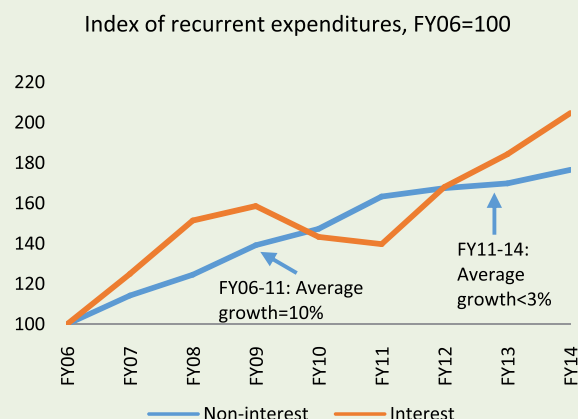
3.3. Around a quarter of recurrent expenditures goes toward interest payments, which have increased in recent years. In FY14, 24 percent of total recurrent expenditure was on interest payments, up from a decade low of 19 percent in FY11 (Figure 3.2). Between FY06 and FY14, interest payment increased faster than other recurrent expenditures. Over this period, interest payments more than doubled while other expenditures grew by 77 percent in real terms (Figure 3.3).

Figure 3.2. Interest expenditure amounts to around a quarter of total recurrent expenditure...



Source: MoF and WBG staff estimations

Figure 3.3. ... and it more than doubled during the last decade, while other recurrent expenditure increased by much less



Source: MoF and WBG staff estimations

3.4. There is some evidence that interest payments have crowded out other recurrent expenditure since FY11 (Box 2). Between FY06 and FY11, non-interest recurrent expenditure grew at an annual average rate of 10 percent (in real terms), increasing from 6 to 7.3 percent of GDP. Since FY11, however, interest payments grew sharply. At the same time growth in other recurrent expenditure slowed sharply, increasing by just 2.7 percent per year in real terms, and decreasing to 6.6 percent of GDP. Interest payments limit resources available for other key expenditures. For example, interest payments between FY11 and FY14 were worth almost the same as was spent on education in the same period and more than double the amount spent on health.

Box 2. Interest costs crowding out other expenditure?

Public debt is among the lowest in the region and debt service costs are also low by regional standards.

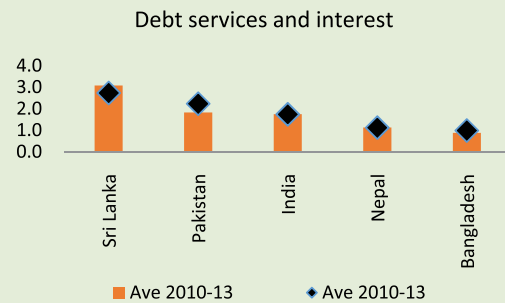
Public debt stood at 34 percent of GDP in 2014, following a steady decline from 42 percent in 2006. Along with Nepal, Bangladesh enjoys the lowest public debt in South Asia, and is well below the regional average of 53 percent of GDP in 2014. In addition, as a share of Gross National Income, debt service is lower than other countries in the region. Finally, new Bangladeshi external debt commitments average the lowest interest rate in the region. This reflects low fiscal deficits and generally good public debt management.

Figure 3.4. Public debt is among the lowest in the region...



Source: IMF WEO, April 2015

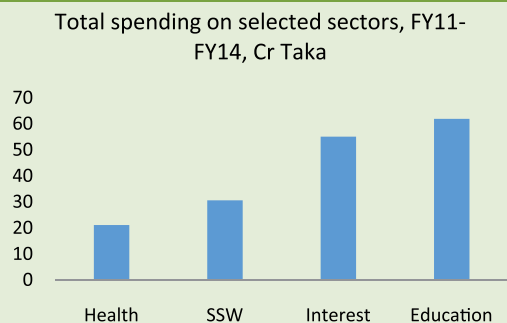
Figure 3.5. ... and debt service costs and external interest rates are reasonable



Source: WBG WDI, 2015

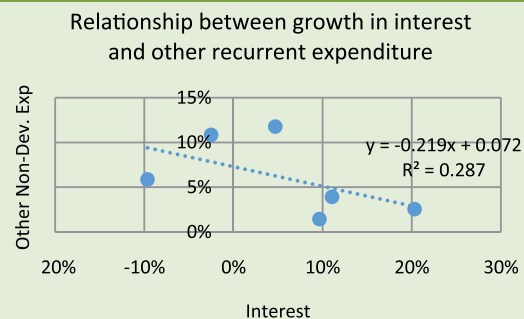
However, with among the world's lowest public sector revenues, interest payments are much larger than spending on other essential areas such as health and social welfare. Despite relatively low public debt and reasonable external interest rates, interest payments already take up a quarter of total recurrent expenditures. Although only a small number of data points exist, there is some evidence that interest payments crowd out other expenditures. In years with the fastest growth in interest payments, other expenditures tend to grow more slowly.

Figure 3.6. Interest dwarfs spending on some social sectors...



Source: MoF and WBG staff estimations

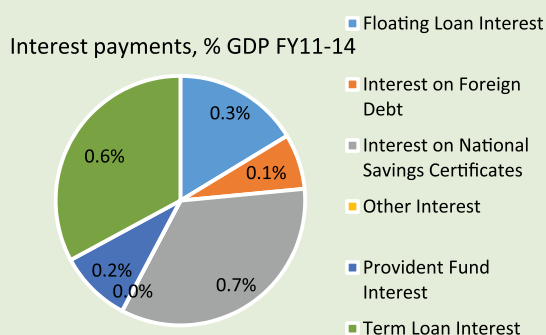
Figure 3.7. ... and when interest payments increase, expenditure growth in other areas fall



Source: MoF and WBG staff estimations

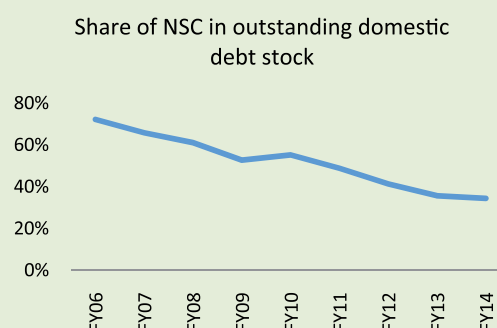
National Savings Certificates (NSC) attract higher rates of interest than some alternative sources of financing but have been declining as a share of domestic debt. NSC pay higher interest than Treasury Bonds of the same period. For example, a five year Treasury bond issued on April 15, 2015 attracted an interest rate of 9.4 percent, while NSC of the same duration pay 13.2 percent – almost 4 percentage points higher. Holders of NSC are also able to withdraw their savings (at lower interest rates) sooner than five years, making them a less secure source of deficit financing. While NSC are surely helpful for the middle classes, who reportedly use them, they are also responsible for over a third of interest costs between FY11 and FY14. Their relative importance in total debt has declined over the past ten years, (but increased significantly in FY15) and some steps have recently been taken to reduce their costs.

Figure 3.8. National savings certificates have higher interest costs than other forms of financing and are responsible for over a third of all interest over FY11-14



Source: MoF and WBG staff estimations

Figure 3.9. ... but their share of total outstanding domestic debt stock has declined year-on-year over the last decade

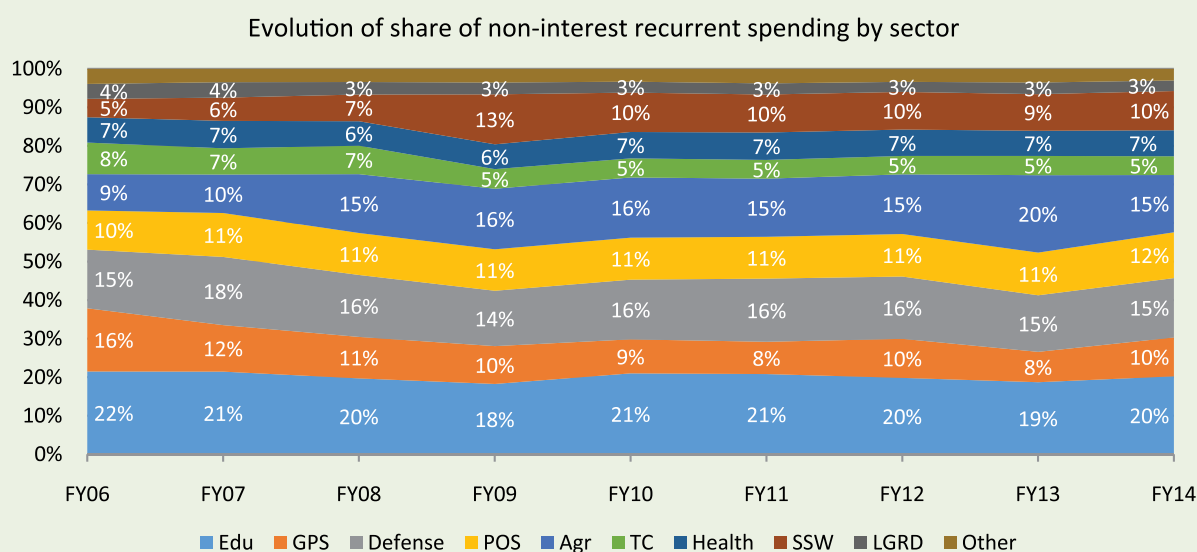


Source: MoF and WBG staff estimations

3.2 Non-interest recurrent expenditures: sectoral classification

3.5. **Sectoral priorities have been fairly consistent over time.** Shares of spending going to the main spending sectors changed only marginally over the last decade revealing mostly consistent priorities over time (Figure 3.10). Education, agriculture, defense and social welfare absorbed the largest share of non-interest recurrent expenditure in FY14. Spending shares allotted to social welfare and agriculture increased, aligned with government priorities of graduating from Least Developed Country status as measured by the Human Development Index, by 2021, something which Bangladesh has already achieved as it is rated as medium human development.

Figure 3.10. Education, defense, agriculture, public order and social welfare absorb most public resources and sectoral spending priorities have been fairly consistent over time



Source: MoF and WBG staff estimations

3.2.1 Social sectors dominate non-interest recurrent expenditures

3.6. **Social sectors absorb close to 40 percent of non-interest recurrent expenditures and social expenditures have doubled in the past decade.** Between FY11 and FY14, around 37 percent of non-interest recurrent expenditure went to education, social welfare and health (Figure 3.11). This represents an increase from 35 percent between FY06 and FY10, reflecting an increase in the importance attached to the social sectors.

3.7. **Expenditure on the social sectors has doubled in the past decade but growth slowed considerably after FY11.** Spending on all three social sectors increased significantly between FY06 and FY14, with health receiving an increase of around 80 percent in real terms during the period, and education an increase of 66 percent (Figure 3.12). Social welfare saw the fastest increase, more than tripling in real terms and increasing from 5 percent of non-interest recurrent expenditures in FY06 to 10 percent in FY14. However, growth in all social expenditures slowed considerably after FY11. Social sector expenditure growth averaged 13 percent between FY06 and FY11 but slowed to just 2 percent since then, reflecting, in part, growth in interest payments.

Figure 3.11. Close to 40% of the non-interest recurrent budget goes toward the social sectors...

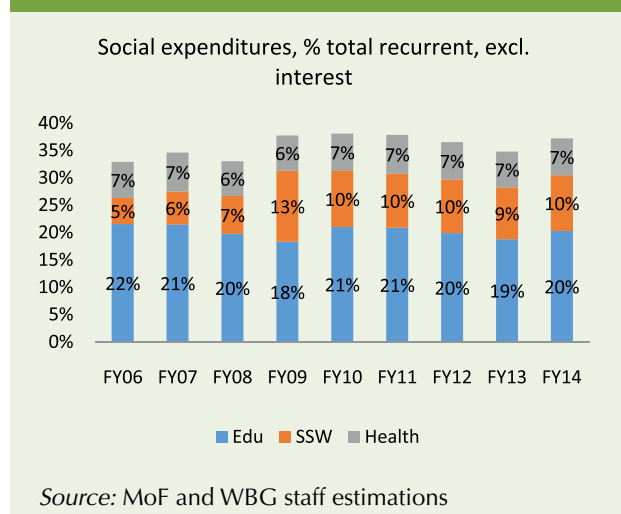
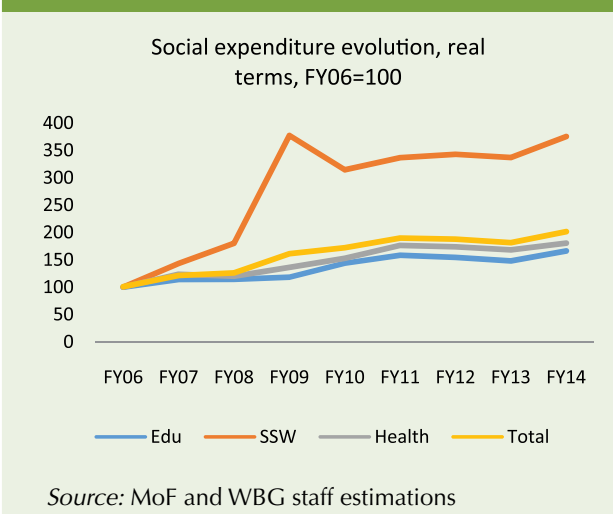


Figure 3.12. ... and expenditure in the social sectors has doubled in the past decade



3.2.2 Agriculture has become an increasingly important part of the budget

3.8. **Agriculture expenditure growth partially reflects an aim to improve rural livelihoods.** As a share of non-interest recurrent expenditure, agriculture expenditure more than tripled over the last decade (Figure 3.13). Combined expenditure on agriculture, environment and forestry, fish and livestock, land, and water increased from 10 percent of total non-interest recurrent expenditure in FY06 to 24 percent in FY14. This increase was driven by increased agricultural expenditure (which grew from 6 to 21 percent of non-interest recurrent expenditure, Figure 3.14). Other areas maintained their expenditure shares. Agricultural expenditure growth came primarily from subsidies (Box 3).

Figure 3.13. Agricultural expenditure more than tripled as a share of non-interest recurrent expenditure over the last decade...

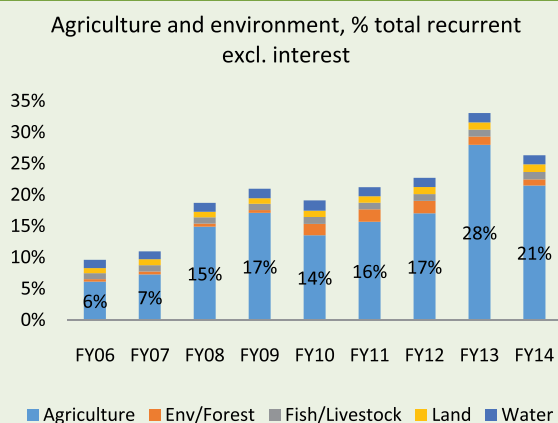
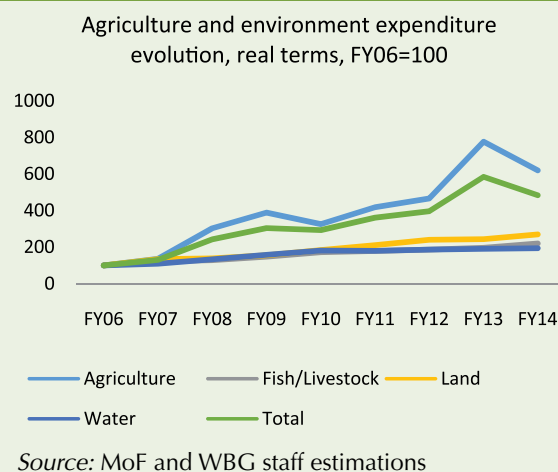


Figure 3.14. ... growing by over 600% in real terms



Box 3. Subsidies and agriculture

Subsidies and incentives were the third largest item in the FY14 outturn, behind only remuneration and grants. They grew from 5 percent of non-interest recurrent expenditure in FY06 to 15 percent in FY14. Much of the growth in expenditure on subsidies are the result of increased agricultural subsidies, with energy subsidies also contributing.

Between FY07 and FY08, agricultural subsidies increased from 2 percent of the non-interest recurrent budget to 9 percent, or from 0.2 to 0.6 percent of GDP. As a result, the agricultural budget increased and two thirds of subsidies are used for agriculture (Figure 3.15), a level that has remained reasonably constant since then. At the same time, subsidies increased from 22 percent of the total agricultural budget in FY06 to 68 percent by FY14 (Figure 3.16).

Figure 3.15. Two thirds of subsidies are spend on agriculture...

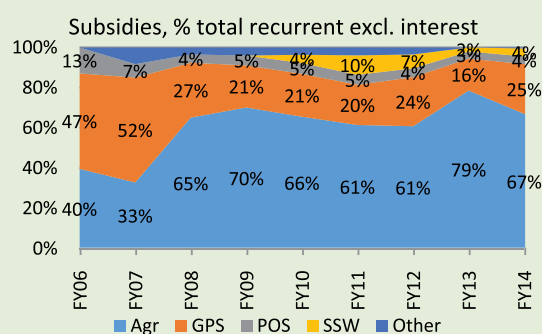
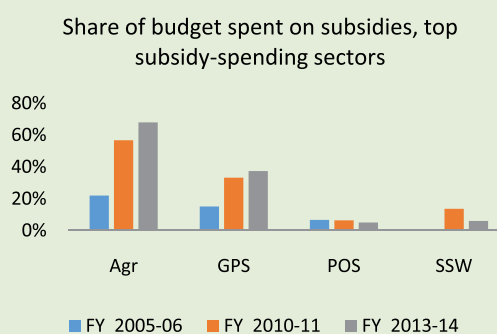


Figure 3.16. ... and two thirds of the agricultural budget is spent on subsidies



Between FY06 and FY14, agricultural subsidies increased more than eightfold (Figure 3.17). Most of this increase occurred in the first two years of the expansion. Agricultural output also grew during the period, though not as fast. Between 2006 and 2013, the gross value added of agriculture increased by 35 percent, or an average of around 4.5 percent per year (Figure 3.18). This compares favorably with other countries in South Asia, where GVA increased by an average of 3.8 percent per year over the period.

Figure 3.17. Agricultural subsidies have increased...

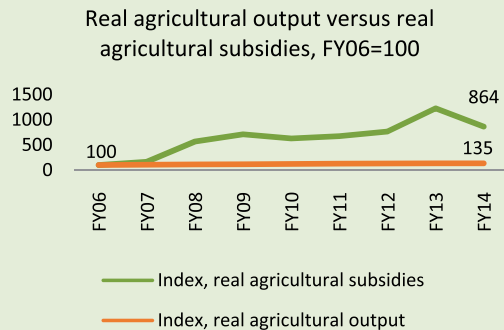
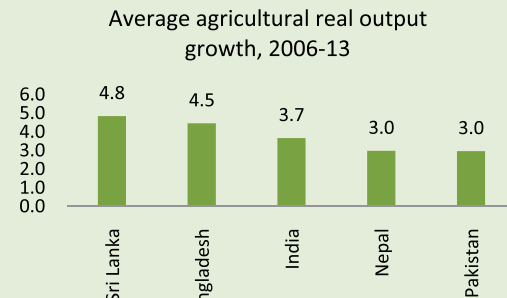


Figure 3.18. ... and agricultural output has grown faster than most countries in South Asia



3.2.3 Infrastructure maintenance expenditure has declined

3.9. While expenditures on social sectors have increased, recurrent expenditures on infrastructure – which largely represent maintenance – have declined. Expenditure on transport and communication, housing and community services, and fuel and energy declined from around 10 percent of total non-interest recurrent spending in FY06 to 6 percent in FY14 (Figure 3.19). While transport and communication represents by far the largest proportion of infrastructure maintenance, it also bore the brunt of the reduction, with almost all of it occurring in FY09. In real terms however, infrastructure maintenance expenditures have remained broadly stable over the last decade (Figure 3.20). With increasing investment expenditure (see chapter 4), this raises the question as to the ability to maintain new capital investments.

Figure 3.19. Infrastructure maintenance expenditure has declined as a share of total recurrent expenditure...

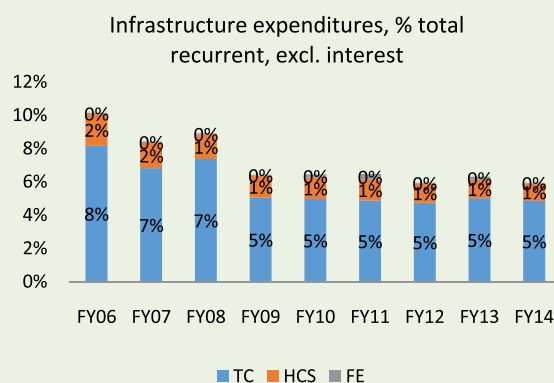
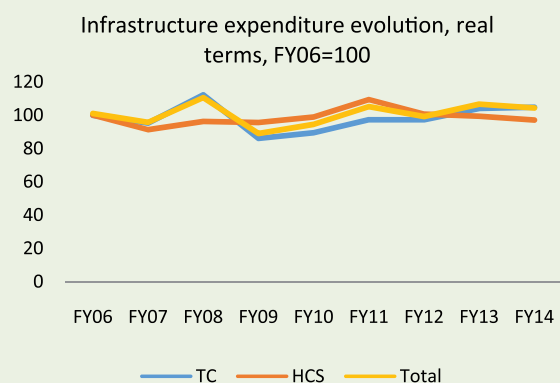


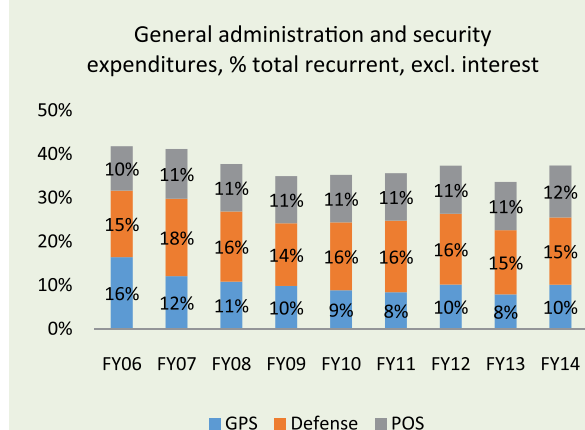
Figure 3.20. ... and has been stable in real terms



3.2.4 General administration and security expenditures are significant

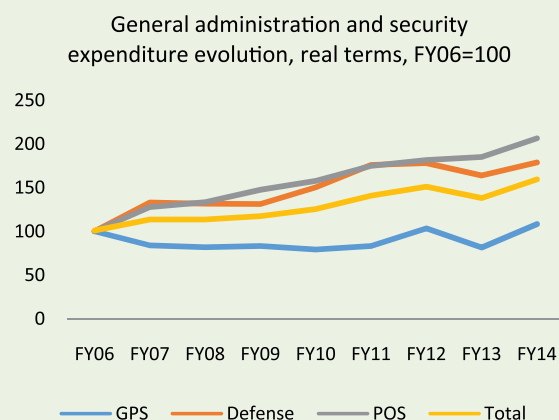
3.10. **General administration and security represent over a third of total non-interest recurrent expenditure but have been stable since FY09.** General administration and security declined from 42 percent of non-interest recurrent expenditures in FY06 to 35 percent in FY09 and remained around the same level since then (Figure 3.21). Most of the reduction came from general public services although the decline is likely to be reversed in FY16 and FY17 with the implementation of pay increases in FY16 and allowances increases expected in FY17, with defense remaining stable at around 15 percent and public order and security at around 11 percent. In real terms expenditure on general public services hardly increased over the last decade, while expenditure on defense and public order and security increased by over 80 percent (Figure 3.22).

Figure 3.21. General administration and security represents a significant proportion of non-interest recurrent expenditure...



Source: MoF and WBG staff estimations

Figure 3.22. ... and while defense and public order and security saw expenditure increases in real terms, general public services expenditure grew little over the decade

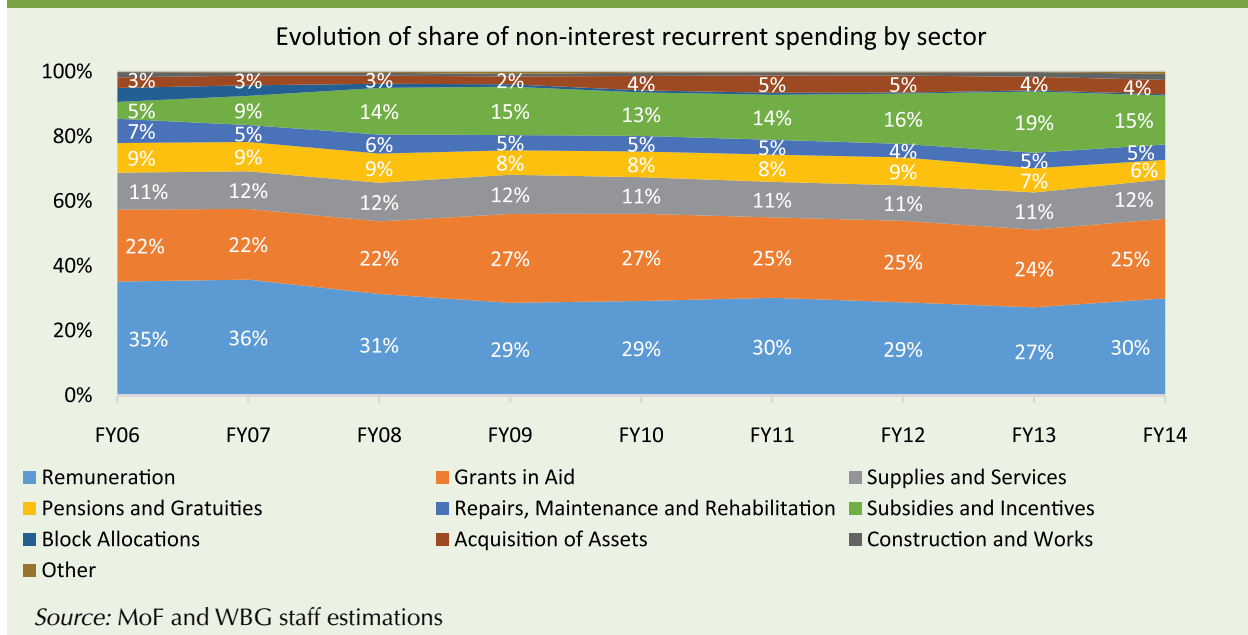


Source: MoF and WBG staff estimations

3.3 Non-interest recurrent expenditures: thematic classification

3.11. **Remuneration, grants, and subsidies dominate non-interest recurrent expenditure.** In total, around 70 percent of all non-interest recurrent expenditure went on these three items in FY14 (Figure 3.23). Around a fifth of remuneration is spent by each of education, defense and public order and security, and a further 13 percent by health. Grants are spent primarily by social welfare and education. The former spend around a third of total grants and they are used primarily for cash transfers to vulnerable groups such as women, children and the disabled. The Ministry of Education spends most of the remainder. While primary and mass education generally has centralized expenditure, higher levels of education tend to receive grants, explaining the high educational grants.

Figure 3.23. Structure of Non-Development Expenditures, excluding interest



3.12. Public sector remuneration growth has been driven by allowances, especially in years without pay increases. Remuneration declined from 35 percent of non-interest recurrent expenditures in FY06 to 28 percent in FY08 and has remained around this level since then (Figure 3.24). In total, between FY06 and FY14, remuneration expenditure increase by around 50 percent (Figure 3.25). This was driven by increases in allowances, which more than doubled during the period. Allowances appear to provide a means of increasing total remuneration during years without public sector pay increases. For example, spending on pay of officers and pay of establishment stagnated between FY06 and FY09. At the same time, allowances increased by close to 50 percent. A pay increase at the beginning of FY10 boosted wages (which increased from 13 percent of recurrent expenditures excluding interest to 17 percent) and resulted in a reduction in allowances as a share of total benefits (declining from 15 to 12 percent of total recurrent expenditures excluding interest).

Figure 3.24. Allowances are an important component of total public sector remuneration and tend to adjust when pay does not...

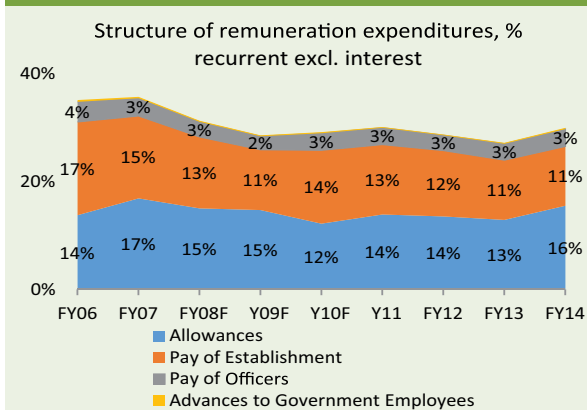
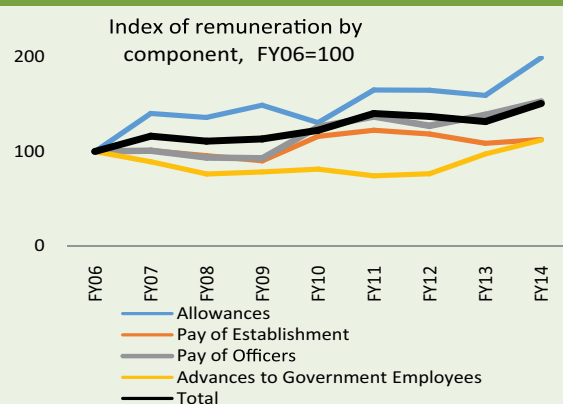
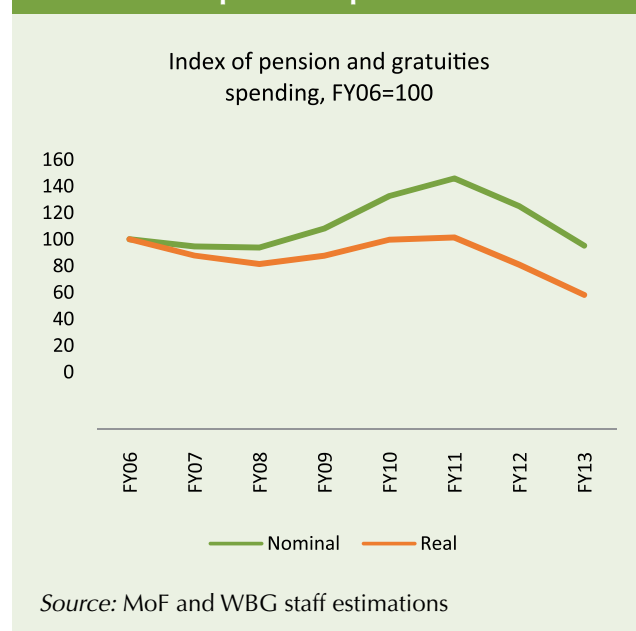


Figure 3.25. ... and allowances increased faster than other components of pay during the past decade



3.13. Reforms reduced significantly expenditures on pensions. After a period of fast growth between FY08 and FY11, the government enacted pension reforms. The retirement age for public sector employees was increased from 57 to 59 years of age. With an estimated 40,000 public servants retiring each year the impact was strong. Expenditure on pensions and gratuities fell from a peak of 9 percent of non-interest recurrent expenditures in FY11 to 6 percent in FY14. Expenditure fell in both real and nominal terms by around one third (Figure 3.26). However, as noted in Chapter 1, although these reforms helped to address challenges related to the Civil Servant Retirement Scheme, there remain challenges with the (unfunded) General Provident Fund (GPF). While the net inflows to the GPF are currently positive and partly used to finance the fiscal deficit, this risks turning negative in the future, presenting fiscal costs.

Figure 3.26. Reforms had a strong impact on pension expenditures



3.4 Recurrent budget accuracy

3.14. Budgeting accuracy is reasonable but has declined somewhat in recent years. In every year over the last decade, budget executions have been between 91 and 96 percent of the revised budget (Figure 3.27). Between FY11 and FY14, all sectors except three achieved an average budget accuracy of between 94 and 101 percent. Only general public services and social welfare had average underspends with expenditures of 85 percent of budget or less, while fuel and energy had an average overspend driven by a single year. Budgeting accuracy was at its peak in FY11 and declined somewhat since then, reaching 91 percent in FY14. However, the high budgeting accuracy was achieved partly thanks to overspend by some sectors, which compensated for underspend by others.

3.15. Overspend by some sectors has been eliminated and some sectors have improved considerably their budgeting accuracy. Overspend, which was particularly high in FY11 and FY12, was eliminated in FY13 and FY14. Some sectors, such as education, have seen considerable improvements in their budgeting accuracy. Education underspend, which contributed a quarter of total underspend in FY07, was reduced year-on-year between FY07 and FY10. Grants – largely as social welfare – were responsible for over 80 percent of underspend in FY11 but this has improved year-on-year since then. However, underspend (or over-budgeting) of grants remained responsible for 11 percent of total underspend in FY14.

3.16. Pensions were responsible for much of the overspend reported in education and other sectors, and the pension reforms corrected this. Overspend on pensions increased significantly between FY09, when they were on budget, and FY11, when they reached over 40 percent above budgeted (Figure 3.28). The pension reforms considerably reduced this and, by FY14, pension expenditure was less than budgeted.

Figure 3.27. Budgeting accuracy is reasonable, although it has been falling in recent years...

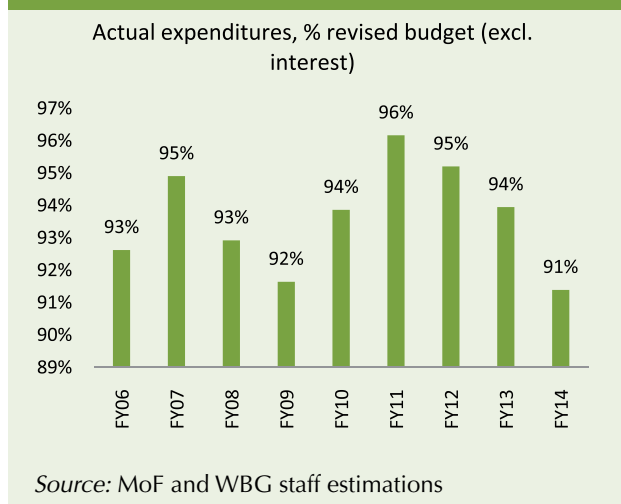
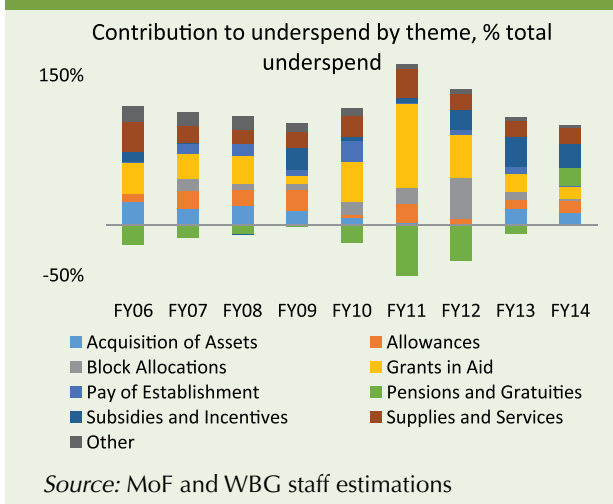


Figure 3.28. ... this is largely thanks to unexpectedly well-contained pension expenditures resulting from reforms



3.5 Conclusions and recommendations

3.17. Economic growth helped to provide additional resources for recurrent expenditure but alone is not enough. Recurrent expenditures grew fast over the last decade, averaging growth of 7.8 percent in real terms per year. Over the same period, economic growth averaged 6.2 percent. However, recurrent expenditure patterns fall into two distinct periods, with spending growing at 10 percent per year between FY06 and FY11, and then at 5 percent between FY11 and FY14. This occurred despite the fact that economic growth was slightly higher in the second period, reflecting the importance of other factors.

3.18. Interest expenditure grew in the second period, potentially crowding out other essential recurrent expenditures. Between FY11 and FY14, interest expenditure increased at an annual average of 14 percent, twice its growth rate during FY06-11. At the same time, non-interest recurrent spending growth collapsed from 10 percent during FY06-11 to less than 3 percent during FY11-14. Between FY11 and FY14, interest expenditure was three times greater than public sector health spending, a third more than social welfare, and nearly equal to education expenditures. Some forms of borrowing – notably National Savings Certificates – provide particularly expensive budget financing, although their importance in total domestic debt has declined in recent years. However, the share of NSCs increased with net NSC sales growing by 184 percent in the first nine months of FY15 relative to the same period the previous year.

3.19. In line with the findings in the Public Expenditure Review of 2010, sectoral financing is broadly consistent with government priorities. Social sectors continue to dominate expenditures; general administration and security remain an important component of the budget; infrastructure (maintenance) expenditures continue to decline; and agriculture continued to grow as a share of the total. The dominance of social sectors and the importance of agriculture are in line with stated government priorities according to the Government's development priority plan.²⁴

²⁴ "Outline Perspective Plan of Bangladesh 2010 to 2021: Making vision 2021 a reality".

3.20. **Since the previous PER, important inroads have been made into one potentially significant problem and some other issues have emerged.** Pension expenditures, which were previously growing rapidly and generating large overspends, have been tamed thanks to reforms. While the reforms have helped to reduce short- to medium- term expenditure on one public sector pension fund (the CSRS), there remain significant challenges with the (unfunded) GPF, which appears “below the line” in the budget. However, the new issue of fast-rising interest expenditure has arisen. The analysis in this PER Update has also revealed that public sector remuneration is largely through allowances rather than wages and salaries.

3.21. **Several potential areas for improvement emerge from this analysis of recurrent expenditure.** This Update does not go into the same depth as the PER-2010 and does not therefore offer sector-specific recommendations. However certain areas emerge as important and several require further analysis:

- *Curbing interest expenditure and ensuring best-value deficit financing would help to reduce the crowding out of other sectors by interest payments.* Continuing to contain deficits is an important part of this and this may include reducing the interest on National Savings Certificates. (This emerges from the analysis above and was also noted in the PER-2010 as a potential improvement area but the situation has become significantly more pronounced.)
- *Improving budgeting accuracy in some areas.* Two notable “quick wins” would be making efforts to better align allocations for pensions with likely needs; and improved accuracy of social welfare payments. Both of these currently contribute to underspend. (This is a newly emerging issue.)
- *Reviewing the efficiency of subsidies.* Subsidies have grown in recent years and take up a large share of the budget. Agricultural subsidies have increased eightfold in real terms over the past decade. Reviewing their efficiency by ensuring that they are achieving their aims and making reductions if necessary would help to free resources for other essential areas. It should be noted that the government argues that subsidies are investments, not recurrent expenditures. (This emerges from the analysis above and was also noted in the PER-2010 as a potential improvement area.)
- *Reconsidering remuneration mechanisms may help to make public sector salaries more predictable and transparent.* Allowances make up more than half of total remuneration and tend to increase in years when public sector pay does not increase. Curbing allowances while making more regular public sector pay adjustment could be considered. (This is a newly emerging issue.)
- *Ensuring sufficient resources are available for maintaining existing infrastructure could pay off in the longer term.* While expenditure on interest and agriculture have increased and expenditure on social sectors and security has increased, infrastructure maintenance has stagnated. Insufficient resources for maintaining existing infrastructure raises questions as to the sustainability of new public sector investment. (This emerges from the analysis above and was also noted in the PER-2010 as a potential improvement area.)

4 DEVELOPMENT EXPENDITURE²⁵

In recent years, the overall composition of investment expenditure has tilted slightly toward public sector with an increasing focus on infrastructure, ICT and social sectors, in line with Government of Bangladesh development priorities. Nevertheless, as also highlighted in PER-2010, to reap maximum benefits out of this investment, planning and execution functions needs to be further strengthened. Overall economic returns to the investment through the ADP portfolio are diluted due to cost and time overruns. There is a need to reevaluate economic and financial viability of the projects for which economic justification appear vague and projects that are significantly delayed.

The findings of the PER-2010 remain relevant today despite a less in-depth analysis. In particular, the development budget is spread thinly, with many projects facing significant delays. In addition, there is a tendency to make significant adjustments between the original and revised Annual Development Plans, suggesting budgeting practices could be improved.

4.1 Investment priorities

4.1. **Bangladesh's development priorities are reflected in the national development plan "Perspective Plan of Bangladesh 2010 to 2021: Making Vision 2021 a Reality" which provides a framework for the sixth five year plan (FY11-15), including details of investment priorities.**²⁶ Several targets were identified with the ultimate aim of achieving a prosperous progressive nation with drastic reduction in poverty. Economic growth is pre-requisite, and, as such attaining average real GDP growth rate of 7.3 percent per year to provide sustainable productive employment to large labor force over the Plan period is a key aim. The Plan also envisaged improvements in human development including health and nutrition, effective population control, progress in all level of education as well as improvement in science and technology along with achievement in ICT to increase the overall factor productivity. Energy and infrastructure development including transport and communication was also targeted to facilitate investment activities, which is key to rapid economic growth. In addition to these, the Plan envisaged sufficient social protection to protect the under-privileged population as well as female welfare and empowerment, and protection of environment.

²⁵ Chapter prepared by Muhammad Waheed.

²⁶ See Planning Commission (2010, 2010b and 2012).

Box 4. Sixth five year plan (FY11-15)

The sixth five-year plan (SFYP) clearly indicates the authorities' investment priorities. The plan envisages the public sector role as a facilitator for attracting private sector investment. Public investment is envisaged to be 22.3 percent of the total planned investment. Indicative resource allocations are projected for line ministries under each sector to implement the strategies. In terms of resource allocation for public development expenditure, the urban sector is projected to get 20.7 percent of the total development resource, followed by energy sector (18.7 percent) and transport (17.0 percent) during the plan period. This indicates the priority of the government is in improving infrastructure, which is followed by the social sector as education and health are envisaged to receive 14.1 percent and 10 percent of the total development allocation respectively during the five year plan period. As discussed below, the Annual Development Plan allocation broadly achieve these priorities. However, there are some concerns as to the extent to which high-level priorities are translated into ministry-level plans.

Currently, the national priorities outlined in the SFYP are not systematically translated into sectoral or ministry-level operational plans. This can lead to disconnect between higher-level multi-annual development plans and actual programming and budgeting decisions. The SFYP outlines the national priorities in a broader framework that does not match the 17 sectors and 31 sub-sectors of the ADP. The limited linkage between the ADP and the SFYP makes the sector prioritization process challenging, and can lead to: (i) the absence of well-constructed sector objectives; and (ii) an absence of resource prioritization between and within sectors. The lack of clear sector objectives can diminish the effectiveness of public investment and hamper implementation of national priorities.

Source: Public Investment Management Review and Reform Road Map for Bangladesh, The World Bank, May 2014

4.2. **In recent years, growth in overall investment has been driven primarily by public sector with the private sector share tapering off.** Recent years have seen marginal rises in gross national investment and significant rises in public investment (Figure 4.1). Gross national investment increased from 26 percent of GDP in FY10 to 28 percent in FY12, declining slightly in FY14. This increase was caused by a significant rise in public investment.²⁷ However, this increase in public investment did not appear to “crowd in” private investment over this period. Investment is still constrained by a number of factors including limited access to serviced land, power and gas shortages, inadequate transport infrastructure and the difficulty in enforcing contracts.

Figure 4.1. Total investment has increased somewhat in recent years...

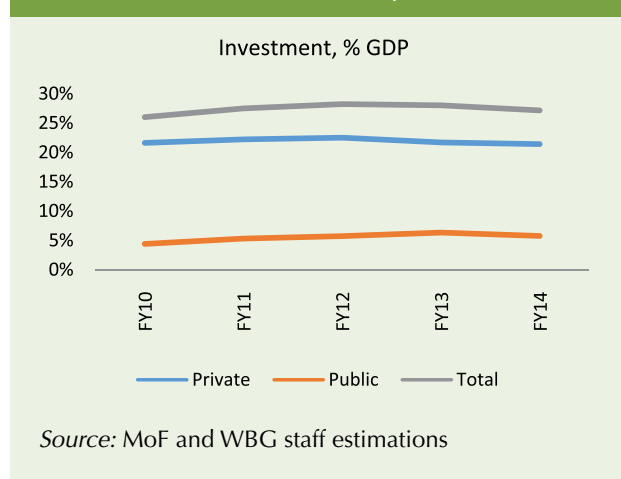
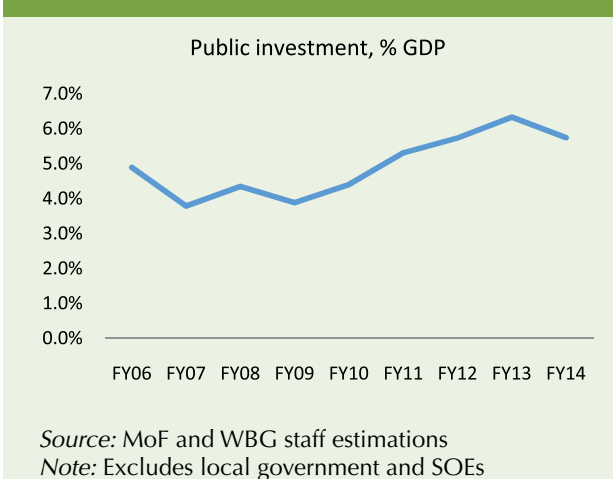


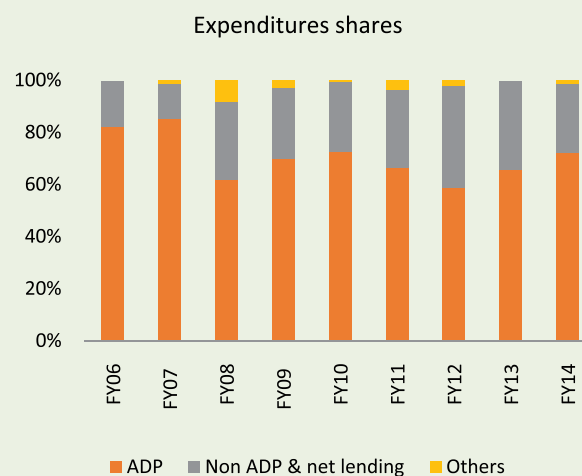
Figure 4.2. ... mostly thanks to increased public investment



²⁷ Total public investment includes ADP plus Non-ADP, local government, and autonomous agencies and State-Owned Enterprises.

4.3. Public investments in infrastructure and social sectors have increased in recent years to tackle some of these constraints. Total public investment increased from 3.9 percent of GDP in FY09 to 5.7 percent in FY14 (Figure 4.2). In real terms, this represents an average annual increase of 15 percent. Although such efforts are a step in the right direction, they do not guarantee the desired results without improving the “soft” aspects of investments such as efficiency in allocations and operations through better governance, as well as ensuring sufficient resources are available to maintain capital investments after they have been completed.²⁸ Without improvement in these areas, public investment alone may not be sufficient to accelerate growth and reduce under-employment and poverty. Therefore, provision of adequate resources to ease these infrastructure constraints is an important first step, but there is also a need to put sufficient focus on the operational, governance and allocation efficiency aspect of these investments as well, as previously highlighted in the PER-2010.

Figure 4.3. ADP are the most important investment expenditures but non-ADP investment is becoming more important



Source: MoF and WBG staff estimations

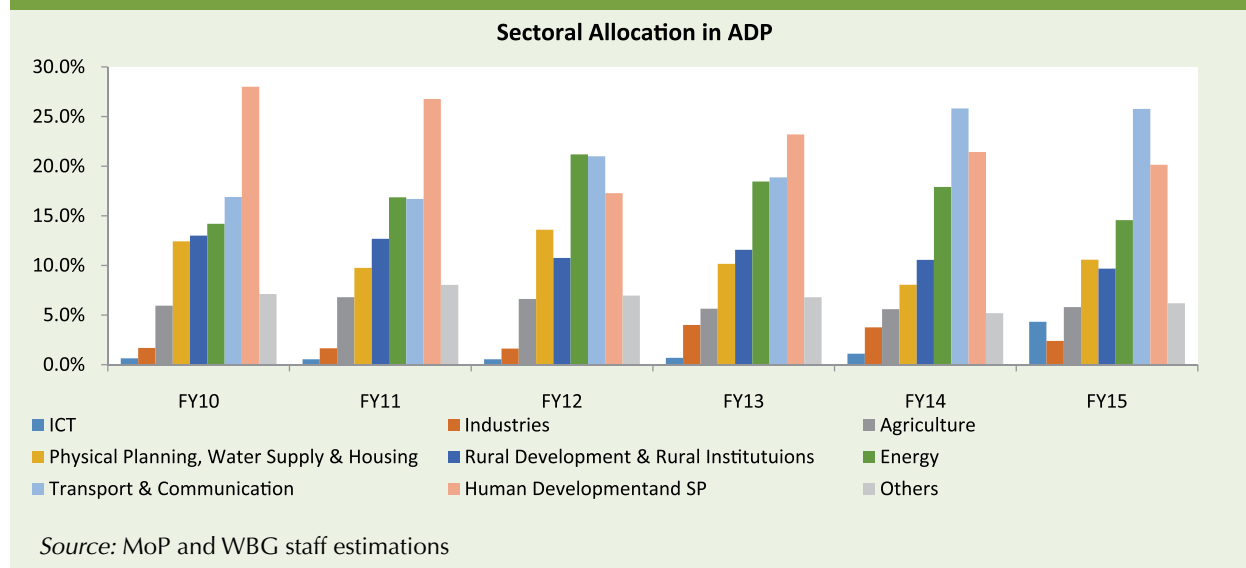
4.4. Public investment is undertaken through two parallel streams — Annual Development Plan (ADP) and non-Annual Development Plan (non-ADP). Most public investments are financed through the ADP. However, an increasing proportion of public investment is financed outside the ADP (Figure 4.3). The share of public investment through non-ADP segment has been steadily increasing over past many years. As noted in Chapter 1, this provides some benefits and poses some challenges. In the following sections we analyze the ADP component of public investment.

4.2 Performance of the ADP portfolio

4.5. ADP allocations since FY10 have broadly reflected the overall growth and development strategy of GoB. Human development, which is one of the major pillar of the strategy has been receiving substantial allocations in absolute terms, however, its share in overall pie declined from 28 percent in FY10 to around 20 percent in FY15 (Figure 4.4). On the other hand, the share of transport and communication in ADP allocation grew steadily from 17 percent in FY10 to 26 percent in FY15, broadly reflecting development priorities of “Perspective Plan of Bangladesh 2010 to 2021” and Sixth Five Year Plan. Interestingly, the share of ADP allocations for the energy sector has declined steadily since peaking at 21 percent in FY12. While the share of ADP allocations for the agriculture sector remained steady at around 6 percent, the share of expenditure allocated to the industrial sector has increased slightly. Among other targeted sectors, allocations to ICT showed a sharp increase from 0.6 percent to 4.3 percent over the period representing the government priority in favor of science and information technology.

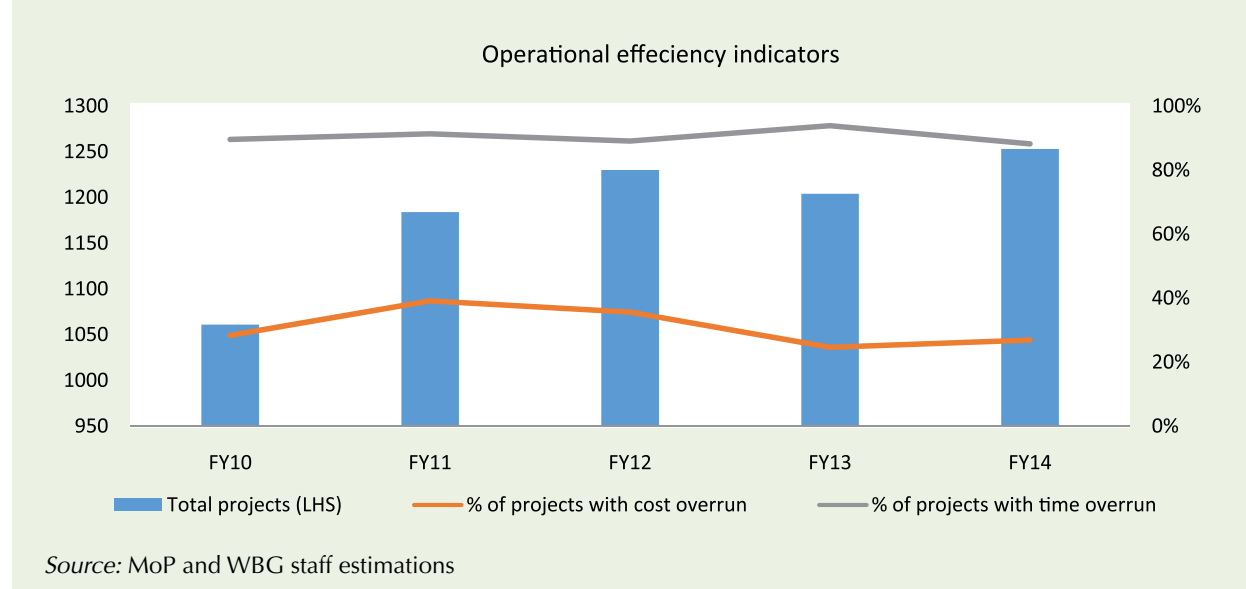
²⁸ As literature suggests that there is no clear cut link established between public investment and growth. Devarajan, Swaroop and Zou (1996) found a negative relationship between public investment and growth, while Calderón and Luis 2014 find evidence that some public investment can boost growth and reduce inequality

Figure 4.4. Sectoral ADP allocations are broadly aligned with development priorities, with significant allocations for human development and an increasing share dedicated to transport



4.6. The size of development portfolio has increased with the inclusion of new projects each year. This practice has resulted in thinning out of the scarce resources with implications for ongoing projects which are already in the portfolio. As a result more than 80 percent projects take more time than envisaged at the time of planning. In addition, there are cost overruns in about a quarter of the completed projects. The cost overruns and delays result in the depletion of economic returns to investment and the deferral of envisioned benefits further in to future (Figure 4.5). This issue has been a persistent problem and has been eroding the efficiency of overall investment portfolio.

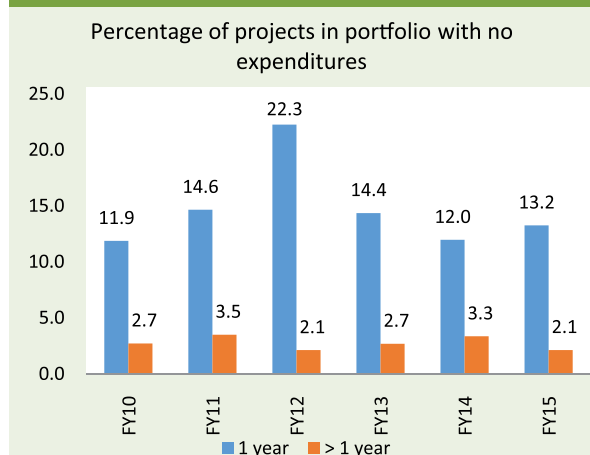
Figure 4.5. Expansion of the portfolio is contributing to cost and time overruns



4.7. **There is a significant lag between the time projects become part of the ADP and the time actual execution starts.** For instance, during FY12, about 22 percent projects were present in the portfolio for a year or more but no expenditure had actually occurred (Figure 4.6). This percentage has declined since then but remains relevant for a large portion of ADP. About 13 percent of projects now experience such delays in execution. Nevertheless, some projects have been in the portfolio for many years but no expenditures has happened. Each year an allocation is made for these items but they remain inactive. Interestingly, some of these have been in the portfolio for more than five years. While the number of projects without expenditure declined from 24 percent to 15 percent since FY12, the portfolio could benefit from a “cleaning”, with the removal of projects that are no longer politically or financially feasible.

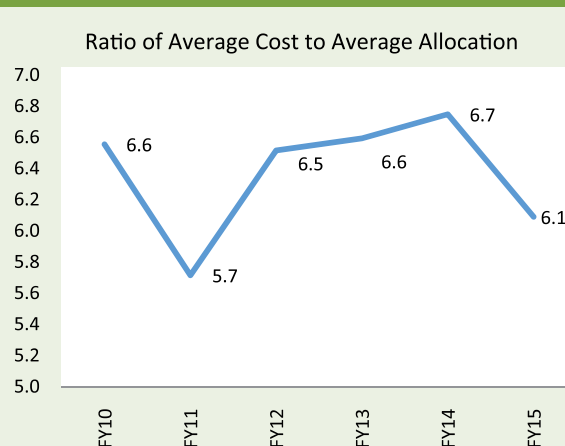
4.8. **The average cost of projects increased faster than average allocation until FY14, suggesting it will take longer to bring a project to completion.** High average cost and low average allocation indicate that a project will take a longer time for full implementation and pose resource demands further in the future. Assuming no cost overrun, even with the improved FY15 ratio, it would take on average 6.1 years to complete a project with current average allocation (Figure 4.7).

Figure 4.6. Many development projects in the portfolio have no expenditures...



Source: MoP and WBG staff estimations

Figure 4.7. ... and allocations have often fallen behind project costs...



Source: MoP and WBG staff estimations

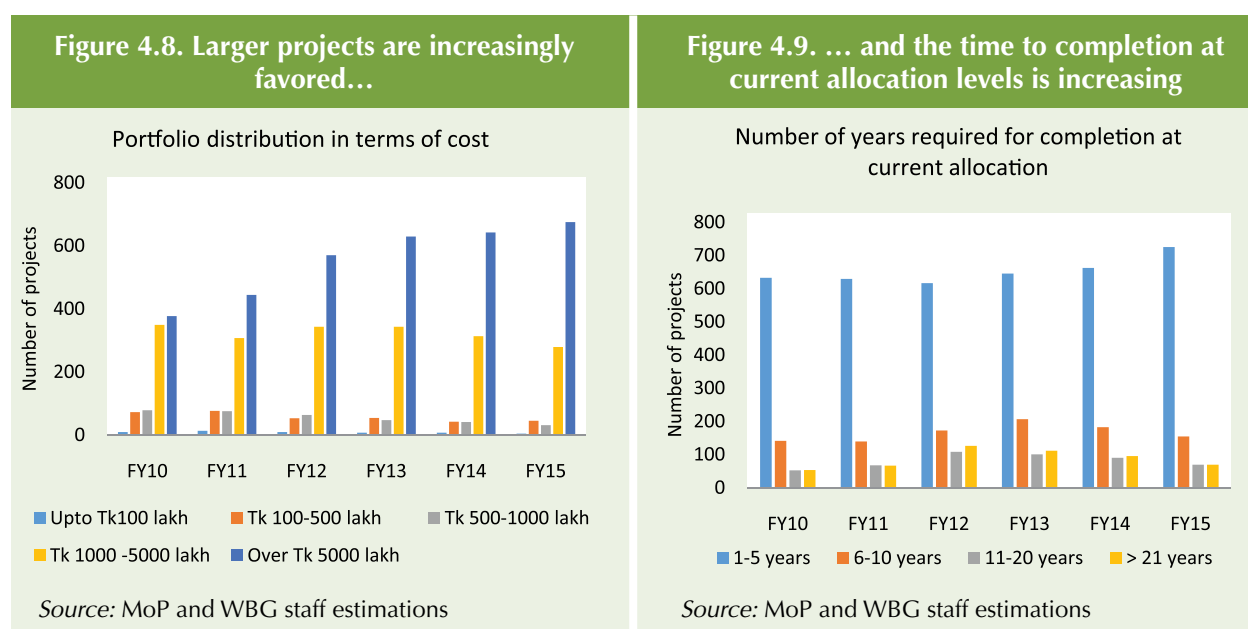
4.9. **A significant portion of development portfolio consists of relatively big projects.** About 90 percent of projects over last six years have cost of Tk 1000 lakh or above (Figure 4.8). This may be an efficient use of resources if small projects take more resources at planning department to monitor and implement, and achieve significantly lower economic or social returns as a result.

4.10. **As a consequence of implementation delays and thinning of overall development outlays, throw-forward²⁹ of the development portfolio is significant.** The inclusion of new projects each year coupled with slow implementation of the existing portfolio contributes to substantial throw-forward of commitments. During FY15, around 92 percent of projects had throw-forward of Tk 50 million or above. Allocation for some projects is clearly insufficient to ensure timely completion. The ADP of FY15 had 66 projects with allocations of Tk 10 million or less. Much of the throw-forward has been recorded in

²⁹ “Throw forward” being defined as claim of development scheme on future development funds. That is additional funds required to complete the project (provided there is no change in scope and cost of the project).

energy sector - around 80 percent projects, followed by transport and communication (55 percent) and agriculture sector (48 percent) - having throw-forward of Tk 500 million or above.

4.11. **About 70 percent of the portfolio is expected to be completed within five years.** A significant portion of investment projects would take more than 5 years at the current level of allocation. For example, during FY15, out of 1034 projects, 725 would take 1-5 years to fully implement with current level of allocation and around 154 projects (15 percent) would be completed in 6-10 years (Figure 4.9). There are around 106 projects which would take 11-100 years to implement while 32 projects (3.1 percent) would take more than 100 years to complete. As discussed earlier, some projects in the ADP program receive allocations year after year but without any expenditure. This may explain only part of the problem, however, as many of the projects that are taking a long time to complete are already under progress with some expenditures already recorded.



4.3 ADP versus Revised ADP: A sign of weak planning

4.12. **There are frequent changes to the number of projects and the resource allocations after the initial budget has been passed** (Figure 4.10). The government prepares the ADP to be presented with the budget document and approved by the legislature. However, changing priorities result in the inclusion of new projects in the ADP without parliamentary approval during the year. Therefore by mid-year a revision has to be made in the ADP to capture these changes. For example, in FY14, the total number of projects was increased by almost 20 percent in the revised ADP compared with the initial ADP. At the same time, allocation declined somewhat. This is not in line with the best budgeting practices and risks focusing on immediate, rather than medium or long-term priorities.

4.13. **The significant changes between the ADP and Revised ADP suggests that planning could improve in some sectors.** Allocation in the RADP tends to be lower than in the ADP of the same year. This suggests that the capacity to implement projects is over-estimated. For instance during FY14, RADP has about 20 percent more projects than same year's ADP. On the other hand, allocations were reduced by 4.4 percent (Figure 4.11).

Figure 4.10. There are frequent large changes in the investment projects and resource allocations included in the original and revised ADPs

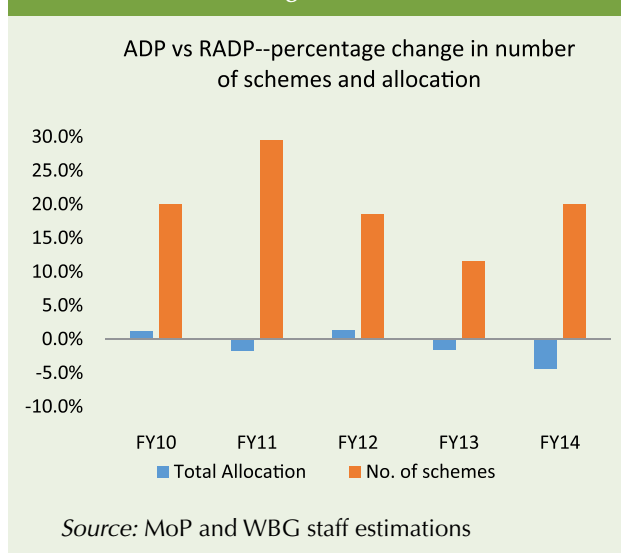
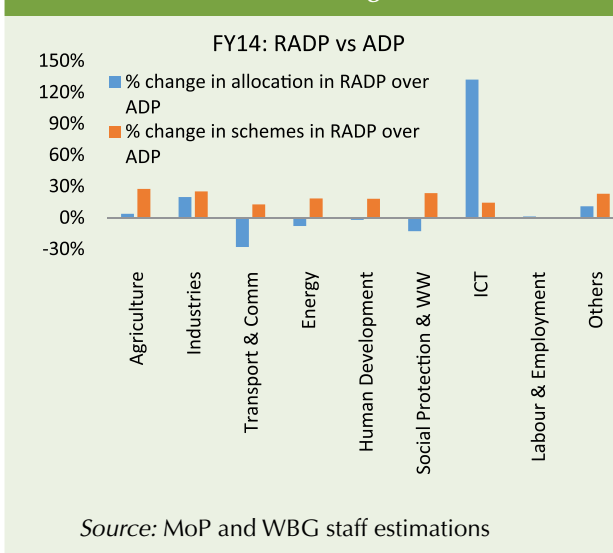


Figure 4.11. ... and the time to completion at current allocation levels is increasing



4.4 Conclusion and recommendations

4.14. Bangladesh has maintained inter-sectoral budgetary resource allocations broadly in accordance with strategic policy priorities. Human development, which is one of the major pillar of the development strategy, has received substantial allocations in absolute terms, although its share in overall pie has declined from 28 percent in FY10 to around 20 percent in FY15. On the other hand, the share of transport and communication sector in ADP allocation grew steadily from 17 percent in FY10 to 26 percent in FY15, broadly reflecting development priorities of "Outline Perspective Plan of Bangladesh 2010 to 2021" and Sixth Five Year Plan.

4.15. Operational efficiency, however, could be improved. The performance of the ADP portfolio in terms of planning and execution has been less than desirable. Resources are spread thinly over thousands of projects. Time and cost overruns, deferral of project benefits long into the future, and declining returns on investment impede overall performance somewhat. The practice of adding significant numbers of small projects with lower allocations just few months after the budget through a revised ADP are not in line with best budgetary practices and may suggest weak planning for the ADP.

4.16. Several enhancements could be made to improve the quality of the portfolio of development projects, and all are in line with findings in the PER-2010, albeit that some issues have become more pronounced. Efforts could include:

- *Reevaluating the economic and financial viability of the projects for which economic justification appear vague and projects that are significantly delayed.* Some projects that have faced significant delays may no longer generate sufficient returns to investment and could therefore be reconsidered.

- *Terminating or restructuring projects that are no more viable or not consistent with the government's development priorities.* There are a significant number of projects in the portfolio for many years but no expenditure has occurred.
- *Eliminating (as many as possible) projects from the next year's ADP where the allocation is less than 10 percent of their "throw forward".* While in some cases, low allocations compared to likely total costs may be justified, many of these projects risk taking years to complete and absorb resources despite not being a priority.
- *Jointly (with the line ministries) evaluating the development program and recurrent budget of each department before approving the line ministry development program.* This will also be important to ensure sufficient resources will likely be available for the maintenance of new capital investments.

5 CONCLUSION

5.1. **Many of the findings of the PER-2010 remain relevant but some issues appear to be more pressing, one appears to have been partially solved, implementation has begun on others, and some new issues have emerged.** Although this PER Update has not gone into the same depth as the PER-2010, this headline analysis has been sufficient to provide broad indications as to some of the key fiscal issues facing Bangladesh.

5.2. **Bangladesh should continue to be proud of its sustainable fiscal stance including its low deficits and public debt.** Bangladesh continues to have among the lowest fiscal deficits in the region and one of the lowest public debts.

5.3. **An important challenge remains that of low revenues, notwithstanding some steps forward.** Revenues fail to generate sufficient resources to meet all of Bangladesh's development challenges. Declining border revenues and revenue stagnation as a share of GDP since FY12 make this issue more pressing. However, progress has been made in the implementation of a Tax Modernization Plan, which includes efforts to increase automation of income taxes, the implementation of Automated System for Customs Data (ASYCUDA) World, and strengthening human resources at the NBR. In addition, a new law to simplify the VAT regime should be implemented from July 2016.

5.4. **In addition to its clear revenue challenge, some key expenditure issues noted in the PER-2010 remain relevant including:**

- **Contingent liabilities as a risk to fiscal sustainability.** This includes notably contingent liabilities through SOEs, including state-owned banks.
- **Operational efficiency of the development budget.** Regular and large adjustments between the original and revised budget, increased numbers of projects – often without expenditures, and significant delays suggest improvements could be made, including by analyzing the portfolio and removing projects that are no longer viable for financial or political reasons.

5.5. **Some issues have become more pressing, including:**

- **Interest costs.** This has become a more weighty issue and there is evidence that interest costs are crowding out other essential recurrent expenditures. Ensuring concessional foreign financing and selecting financing options that minimize interest on domestic debt is required.
- **Efficiency and equity of subsidies.** These have been expanding and take up a large proportion of the budget. Reviewing their efficiency and equity and revising accordingly will be important.
- **Sufficiency of the maintenance budget.** The investment/development budget has increased substantially over the last five years but the recurrent maintenance budget has not increased accordingly. Sufficient resources to maintain new capital investment would help to ensure they pay off in the long run.

5.6. **Steps forward have been taken in some areas, including:**

- **Pension liabilities.** Reforms to the CSRS have helped to tame these expenditures but significant

risks remain with regard to the General Provident Fund.

- **Elimination of overspend of the recurrent budget and reduction of underspend in some areas.** However, some new areas of underspend have emerged. There are some potential “quick wins” to reduce underspend in pensions and social welfare, since these should be reasonably predictable.

5.7. **There are also some newly emerging issues, including:**

- **Public sector remuneration.** Making wage/salary increases more predictable and transparent and reducing the role of allowances in total remuneration would be a step forward.

5.8. **Deeper analysis of fiscal performance in several sectors could be beneficial to understand efficiency of public spending as well as risks and opportunities.** This PER has used headline data to analyze broad fiscal trends and to shed light on some fiscal issues in Bangladesh. Some areas merit deeper analysis with the ultimate aims of ensuring sufficient resources for the public expenditure and increasing the efficiency of public sector spending, while maintaining its sustainability. Areas to consider analyzing in more depth include (but may not be limited to):

- Revenues, including the tax system, policies and management;
- The cost of tax expenditures;
- Sustainability of the GPF (public servant pension system);
- Efficiency and equity of subsidies (either direct or through tax expenditure), including in agriculture, trade, energy and SOEs;
- Resource requirements for the maintenance of existing infrastructure and the link between public investment, total investment and the ADP;
- The extent to which interest payments crowd out other expenditure and potential solutions;
- Some specific sectors – such as health and energy – may benefit from deeper analysis to understand progress in recent years and the outstanding challenges.

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