Budgetary adjustments to deal with the postponement of the new VAT law

Key Messages

Postponement of 2012 VAT Law requires significant early adjustments in the FY18 Budget to tap additional sources of revenue and expenditure saving to increase fiscal space. Automation, process simplification, and dispute resolution may bring additional tax revenues in the immediate future. These are elaborated in an earlier note dated July 22, 2017. This note focusses on developments in non-development capital expenditures, loans and advances, and block allocations in the revenue budget that can generate significant expenditure saving in addition to the usual ADP implementation shortfall. These can be complemented by reforms that will help enhance concessional external financing to ease the pressure on the relatively more expensive domestic financing of the budget deficit.

Background

The FY18 Budget needs to be revisited in response to an estimated Tk 200 billion shortfall in revenue due to the postponement of the implementation of the new VAT law. Although public expenditure will also be lower than target due to the usual implementation shortfall, budget deficit may still rise and its financing mix may need some redesigning. Coping with the revenue shortfall would require additional revenue effort as well as tightening of expenditures in FY18. In this context, the Finance Minister's decision to revise the FY18 Budget earlier than usual is a step in the right direction.

This note, intended as an input to the revision process, constructs three scenarios distinguished by different assumptions on income and other taxes growth (Annex Table-1). All scenarios assume a VAT collection shortfall of Tk 200 billion. Below, the likely outcome is projected followed by an expenditure adjustment scenario and a reform scenario.

Likely Outcomes

With income and other taxes growing at rates experienced in recent years, total revenue shortfall in FY18 can range between Tk 400 – 450 billion. Based on recent trends, revenue growth could range between 10.8 to 13.9 percent relative to the FY17 revised budget. Assuming 80 percent ADP utilization and that the utilization shortfall will apply to aided projects only, as happened in FY17, the budget deficit could range between 5.4 to 5.7 percent of GDP (Annex Table-2). Most of this deficit will have to be financed from domestic sources, ranging between 4.5 to 4.7 percent of GDP. If nonbank borrowings remain at the same level as last year, then bank borrowing will have to rise to between 2.4 to 2.7 percent of GDP. This could create upward pressure on interest rates, risking significant crowding out of credit to the private sector, and enhance inflation risk, particularly if deficit is monetized.

Expenditure Adjustments

The financing burden can be eased by exercising fiscal discipline without risking development impact of the budget. There is room in the budget to apply fiscal discipline measures on non-development capital expenditures as well as government financed ADP projects (63 percent of ADP). Non-development capital expenditures comprise of acquisition of assets and works outside the development budget and investment in shares and equites (including recapitalization of the state-owned banks), and loans and advances. With a 50 percent cut in loans and advances, 25 percent cut in non-development capital expenditures and 5 percent cut in government financed ADP projects, the deficit could range between 4.6 to 4.9 percent of

GDP. Domestic financing could then be between 3.7 to 3.9 percent of GDP and bank borrowing between 1.6 to 1.9 percent of GDP (Annex Table-3).

Reforms

Costly domestic financing can be contained by taking measures to increase the mobilization of concessional external financing. In addition to the above mentioned expenditure adjustments, the government can withhold 50 percent of the Tk 33.27 billion block allocations in the revenue budget, cut internally financed ADP by 10 percent instead of 5 percent, and try to extend VAT coverage sufficiently to attain 13 percent VAT revenue growth (last 5 years' average including growth in the FY17 revised budget estimate). With revenue growth rising to 13.7 to 16.8 percent in this scenario, the deficit ranges between 3.9 to 4.2 percent of GDP. If nonbank financing is limited to the FY18 Budget target and foreign financing is enhanced by about $500 million by reforming the industrial and regulatory environment for jobs friendly investments, bank borrowing can be limited to between 1.4 to 1.6 percent of GDP, a much more tolerable level from the crowding out and inflation points of view.

Expenditure Measures to Consider

The challenges in the implementation of the FY18 Budget can be tackled by a combination of measures to mitigate the revenue shortfall and expenditure adjustments in both the development and the non-development budget. The revenue measures to be considered were identified in a separate policy note dated July 22, 2017. However, managing the implementation may need to rely more on expenditure adjustments because of limited room for immediate revenue gains through policy and administrative measures. Apart from the usual shortfall in ADP implementation, expenditure adjustments in the FY18 Budget can include cuts in:

- Internally financed allocation to low priority ADP projects;
- Non-development capital expenditures that usually are made on purchase of new vehicles, furniture, expansion of public buildings, loans to state-owned financial and nonfinancial enterprises; and
- Block allocations in the revenue budget.

In addition to these adjustments, efforts can be made to enhance external financing by carrying out structural reforms in the regulation, infrastructure management, and the financial sector in particular. This will allow keeping domestic financing of the budget deficit within limits considered tolerable from a crowding out or inflation points of view.

Annex

Table-1: Historic Revenue Growth Rates

	Income Tax	VAT	Other Tax
		%	
FY12-16 avg. annual revenue growth	18.87	12.98	12.56
FY14-16 avg. annual revenue growth	12.87	10.41	15.07
Growth in FY17 Jul-Apr (relative to FY16 Jul-Apr)	15.33	22.05	21.10
Growth in FY17 revised budget over FY16 actual	17.68	23.86	14.60

Source: National Board of Revenue, Ministry of Finance

Table-2: Likely Budgetary Outcomes

	FY17	FY18	Likely Outcomes		
	Revised	Budget	S-1	S-2	S-3
		Tk. in billion			
Revenue	2185.0	2879.9	2487.8	2422.0	2437.8
Expenditure	3171.7	4002.7	3696.0	3696.0	3696.0
Deficit	-986.7	-1122.8	-1208.2	-1274.0	-1258.2
External	287.7	519.2	212.6	212.6	212.6
Domestic	699.0	603.5	995.6	1061.5	1045.7
Bank	239.0	282.0	535.6	601.5	585.7
Non-bank	460.0	321.5	460.0	460.0	460.0
GDP	19560.0	22236.0	22236.0	22236.0	22236.0
		% of GDP			
Revenue	11.17	12.95	11.19	10.89	10.96
Expenditure	16.22	18.00	16.62	16.62	16.62
Deficit	-5.04	-5.05	-5.43	-5.73	-5.66
External	1.47	2.33	0.96	0.96	0.96
Domestic	3.57	2.71	4.48	4.77	4.70
Bank	1.22	1.27	2.41	2.71	2.63
Non-bank	2.35	1.45	2.07	2.07	2.07

S-1: Revenue growth based on FY17; **S-2**: Revenue growth based on FY14-16 average

S-3: Revenue growth based on FY12-16 average.

Table-3: Expenditure Adjustments

	FY17	FY18	Expenditure Adjustments		
	Revised	Budget	S-1	S-2	S-3
		Tk. in billion			
Revenue	2185.0	2879.9	2487.8	2422.0	2437.8
Expenditure	3171.7	4002.7	3517.1	3517.1	3517.1
Deficit	-986.7	-1122.8	-1029.3	-1095.2	-1079.4
External	287.7	519.2	212.6	212.6	212.6
Domestic	699.0	603.5	816.8	882.6	866.8
Bank	239.0	282.0	356.8	422.6	406.8
Non-bank	460.0	321.5	460.0	460.0	460.0
GDP	19560.0	22236.0	22236.0	22236.0	22236.0
		% of GDP			
Revenue	11.17	12.95	11.19	10.89	10.96
Expenditure	16.22	18.00	15.82	15.82	15.82
Deficit	-5.04	-5.05	-4.63	-4.93	-4.85
External	1.47	2.33	0.96	0.96	0.96
Domestic	3.57	2.71	3.67	3.97	3.90
Bank	1.22	1.27	1.60	1.90	1.83
Non-bank	2.35	1.45	2.07	2.07	2.07

Table-4: Expenditure Adjustments Complemented by Reforms

	FY17	FY18	Reforms		
	Revised	Budget	S-1	S-2	S-3
		Tk. in billion			
Revenue	2185.0	2879.9	2551.3	2485.4	2501.3
Expenditure	3171.7	4002.7	3423.5	3423.5	3423.5
Deficit	-986.7	-1122.8	-872.2	-938.0	-922.2
External	287.7	519.2	252.6	252.6	252.6
Domestic	699.0	603.5	619.6	685.5	669.6
Bank	239.0	282.0	298.1	364.0	348.1
Non-bank	460.0	321.5	321.5	321.5	321.5
GDP	19560.0	22236.0	22236.0	22236.0	22236.0
		% of GDP			
Revenue	11.17	12.95	11.47	11.18	11.25
Expenditure	16.22	18.00	15.40	15.40	15.40
Deficit	-5.04	-5.05	-3.92	-4.22	-4.15
External	1.47	2.33	1.14	1.14	1.14
Domestic	3.57	2.71	2.79	3.08	3.01
Bank	1.22	1.27	1.34	1.64	1.57
Non-bank	2.35	1.45	1.45	1.45	1.45