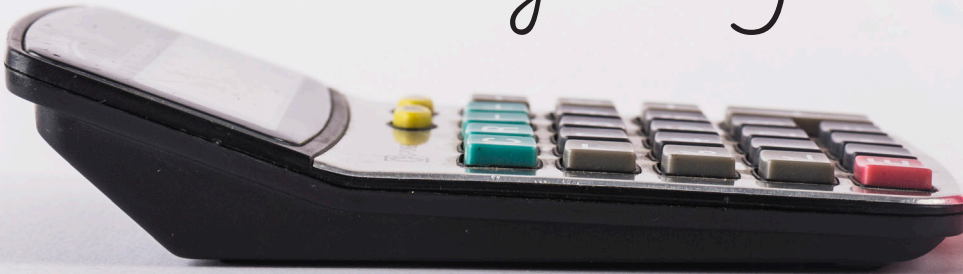


# Budget Deficit



## Budget Deficit in Bangladesh: Causes and Remedies

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### Abstract

Given the deficit in revenue target achievement every year, it is imperative that our fiscal problems are addressed in a way that is both effective and equitable. One way of addressing the problem is collecting more tax revenue by mobilizing internal resources. Tax performance in Bangladesh is not satisfactory. Along with the effective measures of generating more internal resources, the government should also focus on other areas to reduce the budget deficit. The purpose of the article is to discuss the causes of budget deficit and remedies thereof. The article is a theoretical analysis of the topic. Some data have been cited from secondary sources.

**Keywords:** Budget, Deficit, Income Tax, Tax Expenditures, Tax Evasion, Reform, Corruption, Bangladesh.

### Part I: Introduction

One of the most debated macroeconomic issues both in academic and political arena is the budget deficit since 1970s (Barisik and Baris, 2017). Budget deficit occurs when expenditures exceed government revenue. Several factors have been identified that contribute to the cause of budget deficit. For example Jadhav and Neelankavil (2011) states, "Primary cause of deficit is that some components of government spending have a built-in growth multiplier that is much higher than the rate of growth of tax receipts... Secondary causes of deficits include shifts in government spending, changes in the

competitive environment, globalization, presence of shadow economies, fraud in government programs, role of multinationals, and income distribution that affects private consumption expenditures." So whenever government has to spend more than the tax revenue collected deficit occurs. Keynesian and Rikardian School of economics refer to budget deficit as a situation that occurs as a result of reduction in the collection of tax revenue (Tešić et al, 2014). Budget deficits have multiple effects on the economy of a country. The negative consequences of budget deficits emanate from one single initial

effect which is identified as the reduction of national savings (Ball and Mankiw, 1995). Some countries like Bangladesh face budget deficit on regular basis. The government is not capable to raise enough revenue from direct and indirect taxes. There are structural reasons for such budget deficits. The purpose of this article is to argue that, in Bangladesh the main reason of budget deficit is the growing public spending over the years and on the other hand slow growth of the tax revenue from direct and indirect taxes. So to get rid of the budget deficit, there to be a reform in the taxation system. Particularly if tax expenditure is reformed then inter alia that would help in removing the budget deficit. The article is arranged as follows: part I gives an introduction. Part II discusses the state of budget deficit in Bangladesh. Part III discusses the causes of budget deficit. Part IV suggests some measures to combat budget deficit. Part V makes some concluding remarks.

## Part II: Causes and Consequences of Budget Deficit

Budget deficit is commonplace for both the developed and developing countries. As mentioned earlier budget deficit occurs where government spending exceeds the collection of tax revenue. For developing countries like Bangladesh the problem is more acute where budget deficit occurs consistently over long period of time. Consequently the government lacks necessary finance to spend for the development of the country and also reducing the national savings. So it is evident that one of the main reasons of budget deficit is the poor collection of tax revenue both from direct and indirect taxes. The reasons for budget deficit are discussed below:

### I. Tax Evasion and Avoidance:

While tax avoidance has the legal coverage, tax evasion is illegal activities which tend not to report income to the tax authority. Tax evasion in turn accelerates the rate of black economy in the country. In Bangladesh, the rate of black or informal economy was 43.64% in 2014 where it was 20.43% in 1995. From 1995 to 2014 the average rate of black economy in Bangladesh was 26.77% of the GDP (Hasan et al, 2016). Presence of black economy is thought to be one of the main causes of budget deficit (Jadhav, 2011). Given the volume of black economy in Bangladesh it is not surprising that Bangladesh suffers from chronic budget deficit. Even developed country like the USA suffers from budget deficit due to tax gap created by tax evasion. For example, in 2018 the US budget deficit was \$779 billion. The tax gap on the contrary was \$600 billion (Gale and Krupkin, 2019). Of late tax avoidance by

the Multinational Corporations (MNCs) by using means like transfer pricing, treaty shopping has become a global problem. The MNCs are exploiting the loopholes and drawbacks of the international tax rules to the detriment of the tax revenue particularly for the source countries. It is estimated that \$600 billion is lost annually because of tax avoidance by the MNCs (OECD, 2016). MNCs avoid paying tax by exploiting the loopholes existing in the international tax rules. The main methods employed by the MNCs to avoid tax are transfer pricing, treaty shopping, payment of interest for loan to from high tax rate country to low tax rate country, tax avoidance through hybrid mismatch, establishment of conduit corporations etc.

### 2. Tax Expenditure

Developing and transition countries use tax expenditure as an effective tool to pursue economic and social objectives. World Bank (2003) states, "Tax expenditures are concessions that fall outside tax norms or benchmarks...Tax expenditures are deviations from these norms, implemented to encourage behavior deemed desirable by policymakers, and can take a number of forms-including tax exemptions, allowances, credits, deferrals, and relief". Tax expenditures reduce or postpone tax revenue for a specific class of taxpayers relative to a benchmark tax (Anderson, 2008). Tax expenditures create revenue loss for the government and for taxpayers it is a tax relief or reduction in tax liability (OECD, 2010). Tax expenditures might take the forms like allowances, exemptions, tax relief, tax deferrals, and credits. Due to tax expenditures government loses a substantial amount of tax revenue. Particularly the developing countries suffer because of tax exemptions. Tax expenditures have advantages and disadvantages. Most importantly tax expenditure reduce tax revenue that contributes to the budget deficit. Bangladesh tax law contains provisions of various tax expenditures. Mortoza and Begum (2006) state, "The major policy objectives behind the tax expenditure measures in Bangladesh are to accelerate the process of industrialization, to attract foreign currency through increasing exports and foreign direct investment (FDI) and to ensure social security and welfare of low and modest income groups. Tax expenditure measures exist in sectors such as Public Services, Agriculture, Labour and Employment Affairs, Transport and Communication and Social Security and Welfare, etc." Data regarding the amount and impact of tax expenditure are not collected. Mortoza and Begum (2006) conducted a research about the size and nature of tax expenditure in Bangladesh, India and Pakistan. They

found that in financial year 2005 estimated total tax expenditures of Bangladesh in FY05 are BDT 93.45 billion, in which BDT 10.28 billion is direct tax expenditures and BDT 83.17 billion are indirect tax expenditures. It was 0.28 percent of GDP and 3.44 percent of total revenue collection in the country. So it is obvious that government lose a substantial amount of revenue due to tax expenditures.

### 3. Growth of Government Spending

Increased government expenditure can also cause budget deficit. As the population and market grow, government has to spend more and collect enough revenue to spend. Some government spending naturally create budget deficit because of the fact that these type of government spending have in-built growth multiplier. This growth multiplier is much higher than the growth in revenue collection. This is identified as the primary cause of budget deficit. Jadhav and Neelankavil (2011) state, "Government expenses can be broken down into discretionary and non-discretionary. Over time, non-discretionary component grows as a percentage of total budgetary expenses, thereby reducing government's ability to reduce expenses without disenfranchising the electorate...Secondary causes of deficits include shifts in government spending, changes in the competitive environment, globalization, presence of shadow economies, fraud in government programs, role of multinationals, and income distribution that affects private consumption expenditures. Thus there is increase in government spending that surpass the tax receipts. Particularly the non-discretionary component growth necessitates more spending by the government.

So it is evident that tax gap remains one of the dominant causes of budget deficit. All the countries of the world face budget deficit. The developing countries suffer most because of such budget deficit. Bangladesh being a developing country suffers from budget deficit since its inception. The following statistics reveal the truth.

#### Bangladesh: Evolution of the budget deficit

Date	Deficit (M.\$)	Deficit (%GDP)
2017	-8,187	-3.34%
2016	-7,403	-3.36%
2015	-7,726	-3.98%
2014	-5,320	-3.08%
2013	-5,143	-3.38%
2012	-3,949	-2.98%
2011	-4,374	-3.59%

Date	Deficit (M.\$)	Deficit (%GDP)
2010	-3,037	-2.68%
2009	-3,285	-3.21%
2008	-3,686	-4.03%
2007	-1,783	-2.23%
2006	-1,822	-2.57%
2005	-1,905	-2.85%
2004	-1,705	-2.62%
2003	-1,406	-2.34%
2002	-1,502	-2.74%
2001	-2,151	-4.08%
2000	-1,539	-2.92%
1999	-811	-1.56%
1998	-1,273	-2.57%
1997	-1,091	-2.28%
1996	-1,097	-2.38%
1995	-195	-0.44%
1994	15	0.04%
1993	185	0.50%
1992	149	0.42%
1991	183	0.52%
1990	-61	-0.18%
1989	-1,627	-5.08%
1988	-1,428	-4.88%
1987	-1,415	-5.19%
1986	-1,319	-5.46%
1985	-1,164	-5.00%
1984	-1,223	-5.46%
1983	-1,309	-6.80%
1982	-1,264	-6.66%
1981	-1,270	-6.11%
1980	-1,475	-7.00%

Source: Bangladesh Government Budget Deficit <<https://countryeconomy.com/deficit/bangladesh>>.

In the current fiscal year the government presented a deficit budget. The budget forecasts income from tax revenue to the tune of tk 325 600 crores. This is against the income target of tk 377810 crores. The total deficit stand at tk 145 380 crores.

### Part III: Measure to Reduce Budget Deficit

Reforming tax expenditure: As mentioned earlier tax expenditures remain one of the major causes of budget deficit. Tax expenditures narrow the tax base and for the government it becomes difficult to make any revenue forecast. Moreover, tax

expenditures make tax statute more complex and the cost of enforcement increases. Tax expenditure also undermines the tax system fairness by allowing concessions to any particular class of taxpayers. It can demoralize the regular taxpayers who do not get the tax expenditure advantage. The World Bank (2003) states, "Tax expenditures hold an attraction for policymakers as a way to stimulate markets and encourage certain behavior among tax-payers. But 25 years of experience with tax expenditure programs in OECD countries suggest that policymakers need to guard against these programs' potential down-sides". Tax expenditure is a deviation from the normative or benchmark tax system. Swift (2006) says, "Bangladesh's tax system is plagued with numerous exemptions and tax holidays for both income tax and VAT. As a result, its net tax revenue, on average was 7.9 percent of GDP while its fiscal deficit on average was 3 percent of GDP from 1995 to 2004, and its total public debt was 51 percent of GDP by 2002. The large number of tax expenditures contributed to the low tax revenue received, as well as to the cause of fiscal deficit and high public debt, leading to fiscal unsustainability". Under the circumstances there must be reform in the volume and nature of tax expenditures. Tax expenditures should be integrated in the budget in its totality to ensure accountability in fiscal policy. Swift (2006) states, "Close coordination of tax expenditures and direct expenditures during budget appropriation could ensure that overlap or duplication can be avoided. That also facilitate explicit trade-offs between tax expenditures and direct budget expenditures". Government should carefully craft the tax expenditure policy. There should be an overall impact assessment regarding the performance of the tax expenditures. Duplication must be checked. Unnecessary tax exemptions should be removed. A thorough reform in the tax expenditure sector might help in reducing the budget deficit. However, reform in tax expenditure might not be so easy because of reasons more than one. As Mills (2017) argues, "From a political point of view, however, reform may not be that easy. Politicians (at least in countries where markets are politicised, like in many developing countries) like discretionary investment incentives because they facilitate political and administrative corruption. Moreover, the cost of tax incentives is usually unknown and dispersed over a long time while the political benefits, as well as the private benefits to the person entitled to make the decisions, are immediate. Finally, incentives are easier to provide than infrastructure, labour skills or other investment climate improvements". Sometimes it might be practically difficult to bring reform for

political reason. In that case Mills (2017) suggested two solutions. One is to make the tax expenditures less discretionary and public disclosure policy. If these are followed there will be transparency in this sector.

#### **Expanding Tax Base:**

No other prescriptions are found in a frequent manner for the developing countries tax administrations than the one that behests to broaden the tax base (Bird, 2007). Two other important prescriptions are reducing the tax rate and improve tax administration. Like many other developing countries, Bangladesh has a narrow tax base. Bangladesh has a big population of 140 million. But the number persons registered in the tax net is 3.4 million only. Again among these registered TIN holders, only one third submits income tax return. Consequently, as Mascagni et al (2014) a large share of GDP remains outside tax net. It is observed that countries with low income have narrow tax base than high income countries (Besley and Persson, 2014.) The IMF makes some recommendations for the developing country's tax administrations. One of the recommendations is the broadening of the base of personal income tax. So in Bangladesh if the budget deficit is to be faced with increased tax revenue it is imperative that tax base be broadened immediately without further delay. If the tax base is broadened then tax rate can be reduced and the incidence of tax can be equally distributed among the taxpayers.

#### **Eradicating Corruption in Public Sector:**

Corruption remains a menace to the development of the developing countries economy. According to Transparency International (2018) corruption reigns in almost all public sector worldwide. Corruption eats up a major chunk of government revenue. It also digests a substantial portion of government budget by diverting the money to unnecessary and inefficient projects for ulterior motive of the government officials. Ahmed and Alamdar (2018) state, "Budget deficit will have magnified effects if accompanied with high level of corruption. Reason behind is that revenue and expenditure sides of government budget are strongly affected by public sector corruption. At the revenue side, less revenue is collected due to bribes of public officials. Public officials give fee waive, or exemption in various charges to the people after taking bribes. On the other side government expenditures are falsified or misrepresented with their composition. Many inefficient projects are taken for investment on account of bribes". So to reduce budget deficit public

sector corruption must be eradicated or at least to be brought to a tolerable limit. If corruption can be reduced there will be an increase of government revenue and misuse of public fund for private use can be checked. Some suggests that the composition of government expenditure should prefer the sectors that are less susceptible to corruption (Mauro, 1998). Mauro (1997) states, "Corrupt government officials may come to prefer those types of expenditure that allow them to collect bribes and to keep them secret." The World Bank (2000) says, "Corruption hurts the poor most severely: It diverts public services from those who need them most and strangles private sector growth. Corruption undermines public support for development assistance by creating an erroneous perception that all assistance is affected by corruption". In Bangladesh there is Anti-Corruption Commission (ACC) to deal with the cases of public corruption. But despite its strong presence and definite law corruption does not show any sign of retreat. Zafarullah and Siddiquee (2001) states, "Bangladesh presents a typical case where corruption has found a remarkably fertile ground, despite the 'existence' of several mechanisms, albeit ineffective, for tackling it. Presently, corruption in Bangladesh is so pervasive that it has evoked widespread condemnation from within the country as well as from outside. Externally, it has already caused a national embarrassment as the country has been branded as the most corrupt nation in the world".

### **Improving the Tax Administration**

Of developing countries Tax administrations are regarded as weak and inefficient. The result is the low collection of tax revenue. To collect the much needed revenue through tax rate cut and expanding the tax base requires an effective tax administration. Even the best tax policy is destined to collapse if it is not effectively implemented. Bird (2007) states, "The importance of good administration has long been as obvious to all concerned with tax policy in developing countries as its absence in practice... How a tax system is administered affects its yield, its incidence, and its efficiency. Administration that is unfair and capricious may bring the tax system into disrepute and weaken the legitimacy of state actions. In many transitional countries, for instance, the failure to improve tax administration when introducing new tax structures resulted in very uneven tax imposition, widespread tax evasion, and lower than anticipated revenue. In developing countries, corporate tax liabilities are often negotiated rather than calculated as set out in the law." So it is imperative that tax administration be


improved to implement tax reform with the end in view of collecting tax revenue to meet up budget deficit. To improve the tax administration, Bird (2007) suggest some measures. They are the political will of the government to make the tax administration effective, a conspicuous policy to achieve the goal and necessary resources to that end. Besides the domestic taxation issues, the tax administration of developing countries, more particularly of Bangladesh must keep abreast of the latest development in the arena of international taxation. To combat the Base Erosion and Profit Shifting (BEPS) by the MNCs, the tax administration must be prepared to face the challenges posed by the digital economy and the aggressive tax planning by the MNCs. Hartnett (2016) states, "It is important for developing countries to have a full understanding of the BEPS reforms, and the OECD is to be commended for its achievements to date, but putting in place an effective and efficient tax administration must be the first step... In some countries, the tax administration has lost the trust and respect of its citizens and business alike due to a range of factors including: failure to tackle corruption inside the organization, failure to address dishonest competition – e.g., computer parts imported as fruit to evade duties, bribery of judges, cash wages in brown envelopes to avoid withholding, and governments all too ready to criticize tax administrations in order to court public opinion". Capacity of the tax administration requires the understanding of a complex and multi-level environment. Various actors within municipal set up play a vital role in facilitating an enabling environment for successful capacity building and necessary reform (Brumby, 2016).

### **Reducing Unnecessary Public Expenditure**

Increase in the collection of tax revenue is necessary to meet up the increasing volume of public expenditures. On the other hand, it is also imperative to reduce unnecessary and unrealistic expenditure. Sanderante (2013) argues, "It is the difficulty of containing government expenditure that makes the containment of the fiscal deficit a daunting task but an immediate necessity". It is wrongly perceived over the years that government has endless money basket. This perception is not fair. Government earns its income from the tax revenue. Unless enough revenue is collected, it becomes difficult for the government to provide necessary money for public expenditure. While reducing public expenditure government can prioritize the sector to be financed. Suggestions are being put forward how to curtail government expenditure. For example Riedl (2003) suggests that to reduce budget deficit

government should form a constituency for limited government and lower taxes, local programs to be turned back to the central government, privatization should be accelerated on the ground that private actors perform better than the government ones, cancelling irrelevant programs and reform wasteful programs, put together duplicative and contradictory programs, converting several remaining programs into vouchers, terminating programs rather than trimming them, procedural complexities should be removed to save time and money. However, for a democratically elected government it sometimes becomes very difficult to reduce its spending. It is quite understandable. But given the resource constraint spending should be contained. For Bangladesh it is more appropriate. Because of the recent graduation to the status of middle income earner country, Bangladesh now has to rely on its own feet for resources to be spent for the people.

## Conclusion

Budget deficit is a regular phenomenon of most of the economies of the world. Budget implementation largely depends on the appropriate mobilization of internal resources i.e., collection of tax revenue from both direct and indirect tax sources. Collecting taxes is a mountainous job. While developed countries have been able to collect taxes to the required level in most of the cases, developing countries struggle to collect the same. Bangladesh is no exception. Needless to say, since independence Bangladesh made remarkable improvement in terms of economic development and tax collection experienced noticeable growth. However, tax GDP ratio is still low compared to other neighboring nations. The size of the budget is being increased every year and more money it to be poured into the exchequer through collection of taxes. On the contrary, the collection of revenue has not yet reached to the expected level. Causes are multiple ranging from weak tax administration, corruption, narrow tax base, tax avoidance by MNCs, lack of tax culture and many more. Under the circumstances it is imperative that government focuses on the capacity building of the tax administration and also improving the tax culture by inciting patriotism among the people of the country. At the same time to get out of the budget deficit, the government should attempt at reducing the public expenditure. Otherwise the continuing budget deficit will reign the economy of Bangladesh for days to come putting the economy at stake. 

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