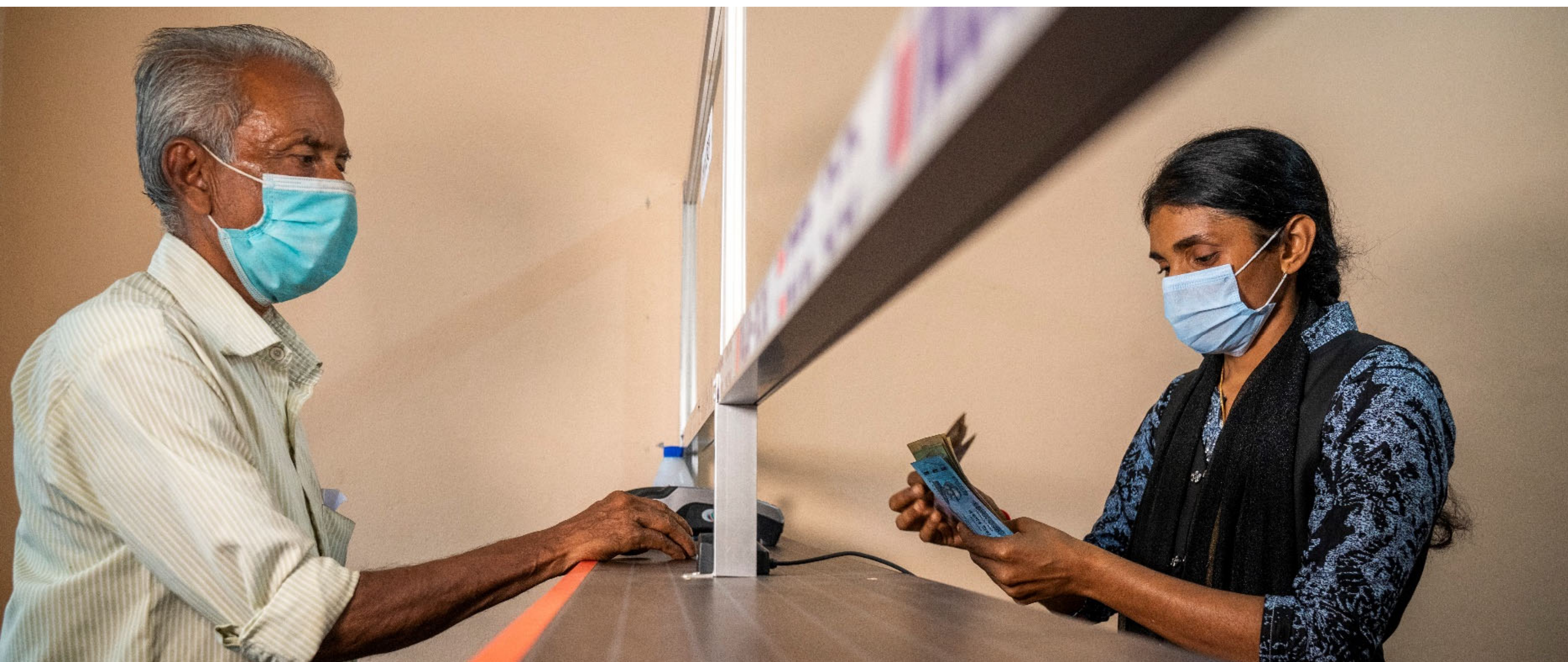
April 2024

Bangladesh Development Update

Special Focus: Strengthening Domestic Resource Mobilization



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Abbreviations

ADB	Asian Development Bank
ADP	Annual Development Programme
ADR	Advance-to-Deposit Ratio
AEs	Advanced Economies
BAFEDA	Bangladesh Foreign Exchange Dealers Association
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BDT	Bangladeshi Taka
BIN	Business Identification Number
BITAX	Bangladesh Integrated Tax Administration System
BoP	Balance of Payment
BPM6	Balance of Payments Manual 6
BSEC	Bangladesh Securities and Exchange Commission
CAD	Current Account Deficit
CBPS	Cox's Bazar Panel Survey
CY	Calendar Year
DRP	Displaced Rohingya Population
DSA	Debt Sustainability Analysis
DSE	Dhaka Stock Exchange
EDF	Export Development Fund
EFD	Electronic Fiscal Devices
EMDE	Emerging Market and Developing Economies
EPZ	Export Promotion Zone
EU	European Union
FDI	Foreign Direct Investment
FSR	Financial Stability Report
FTA	Free Trade Agreement
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GVC	Global Value Chain
HC	Host Community
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offerings
IPR	Intellectual Property Rights
IRC	Interest Rate Corridor
IVAS	Integrated VAT Administration System
LC	Letters of Credit
LDC	Least Developed Country
LLP	Loan Loss Provision
MLT	Medium and Long-Term
MPI	Multidimensional Poverty Index
MPS	Monetary Policy Statement
NBR	National Board of Revenue
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NPL	Non-Performing Loan
NSC	National Savings Certificate
OBS	Offshore Banking Units
PCA	Prompt Corrective Action
PSPR	Poverty and Shared Prosperity Report
PTA	Preferential Trade Arrangement
QLFS	Quarterly Labour Force Survey
RMG	Ready-made garments
ROA	Return on Asset
ROE	Return on Equity
SDF	Standing Deposit Facility
SEZ	Special Economic Zones
SLF	Standing Lending Facility
SMART	Six Month Moving Average Rate of Treasury Bills
SME	Small and Medium Enterprises
SOE	State-owned Enterprises
SRO	Statutory Regulatory Order
TCB	Trading Corporation of Bangladesh
TIN	Tax Identification Number
VAT	Value-added Tax
VOP	VAT Online Project
WASH	Water, Sanitation, and Hygiene
WFP	World Food Programme
WRI	Wage Rate Index
WTO	World Trade Organization

Executive Summary

Bangladesh's post pandemic recovery faces continued headwinds in FY24. Economic conditions worsened in FY23 as inflation increased and the balance of payments deficit widened. The introduction of a multiple exchange rate regime in September 2022 disincentivized foreign exchange inflows, leading to a financial account deficit. Foreign exchange rationing measures were implemented to restrict imports, which resulted in shortages of key intermediate goods, capital goods, gas and energy.

Real GDP growth slowed significantly to 5.8 percent in FY23 from 7.1 percent in FY22, due to weakening private consumption and investment. Persistent inflation eroded consumer purchasing power. Tight liquidity conditions, rising interest rates, import restrictions, and increasing input costs stemming from upward revisions in the administered energy prices hampered investment activity. The contribution of net exports to growth increased, led by a sharp contraction in intermediate and capital goods imports. Industrial and services growth moderated on the supply side. Industrial sector weakness continued in FY24, with a manufacturing-driven 3.7 percent decline in the index of industrial production (IIP) year-on-year.

To rein in inflation, Bangladesh Bank (BB) continued to tighten monetary policy in early FY24. BB introduced an interest targeting framework in FY23 to better signal its policy stance. However, monetary transmission remains weak due to a variable cap on lending rates, and the real policy rate remains negative. The banking system continues to face tight liquidity conditions due to unsterilized BB foreign exchange sales and weak deposit growth. Private sector credit growth slowed further in FY24, reflecting a broader slowdown in investment. The non-performing loan (NPL) ratio in the banking sector remains elevated, and even this elevated ratio understates banking sector stress due to lax definitions and reporting standards, forbearance measures, and weak regulatory enforcement. BB has proposed bank mergers and introduced a Prompt Corrective Action (PCA) framework to address the vulnerabilities in the banking sector.

The decline in foreign exchange reserves has moderated. The BoP deficit moderated during the first half of FY24 driven by a surplus in the current account. However, the financial account deficit has widened further. Expanding net outflows on account of net trade credit reflected increased divergence between export shipments and receipts, the slowdown in trade flows and private sector credit. A decline of Medium and Long Term (MLT) loans added to the financial account deficit. The interbank exchange rate was inadequate to clear the forex market, leading to a severe shortage of dollars. Continued interventions by BB in the forex market led to a depletion in official gross international reserves from US$ 24.8 billion to US$ 20.8 billion in the first eight months of FY24.

The fiscal deficit moderated marginally to 4.4 percent of GDP in FY23 from 4.6 percent in FY22. Subdued revenue growth was offset by deferred capital investment and limited public sector wage growth. The public debt-to-GDP ratio increased to 35.0 percent but remained sustainable, with a low risk of debt distress. To contain subsidies, the government cut export subsidies to almost all sectors, increased electricity prices, and adopted a market-based pricing formula for liquid fuels, linked with global prices. Net borrowing from the banking sector declined in the first three quarters of FY24.

Real GDP growth is projected to remain relatively subdued at 5.6 percent in FY24, compared to the average annual growth rate of 6.6 percent over the decade preceding the COVID-19 pandemic. Persistent inflation is expected to weigh on private consumption growth, and shortages of energy and imported inputs combined with rising interest rates and financial sector vulnerabilities are expected to dampen investor sentiment. Relatively slower growth is projected to persist in FY25, at 5.7 percent, driven by a modest recovery in private consumption supported by a moderation in inflation. Investment recovery will need support from improved implementation of large public

investment projects. On the supply side, this will be reflected in higher industrial growth, even though services growth is expected to remain subdued. Growth is expected to increase gradually over the medium-term as monetary, exchange rate, financial and structural reforms are implemented.

Even though political uncertainty has diminished with a new cabinet taking oath after the national elections held in January 2024, downside risks to the outlook are significant. Inadequate progress in monetary and exchange rate reforms may result in a further decline in foreign exchange reserves and persistent inflationary pressure. Tighter liquidity conditions could exacerbate vulnerabilities in the banking sector. Fiscal risks include a revenue shortfall, potential financial sector fiscal liabilities, and deficit monetization.

Expediting structural reforms are needed to promote economic diversification and integration into Global Value Chains (GVCs) and strengthen resilience over the medium to long term. Critical reforms include developing the intellectual property rights (IPR) regime and strengthening the framework for foreign direct investment. An efficient resolution framework for NPLs is urgently needed. In this regard, conducting a comprehensive Asset Quality Review of the largest banks, establishing legal frameworks for the creation of an NPL market, strengthening corporate governance of the state-owned commercial banks and efficiently implementing regulations such as the Prompt Corrective Action framework for weak banks are crucial steps. Moving forward with forced bank mergers may be counterproductive without a thorough assessment of asset quality. A consolidation process will require careful assessment and prudent implementation of procedures to avoid weakening good banks acquiring bad banks, and an assessment of the asset quality of weak banks will be required.

The special focus section of this report discusses how domestic revenue mobilization can be strengthened to support Bangladesh's development strategy. Bangladesh's revenue as a share of GDP is currently 8.2 percent of GDP (FY23), among the lowest in the world and significantly below peers. Critical public investments in energy, transportation, municipal infrastructure, and human capital development are significantly constrained by the very low levels of government revenues. Reforms to increase domestic revenue generation will be critical for sustaining future economic growth. There is potential to collect three times more VAT if policy and compliance gaps can be reduced. The recently updated Income Tax Act (2023) is an opportunity to increase income tax collection by expanding the tax base through improved compliance and tax services. Administrative reforms could modernize manual and paper-based processes and enhance transparency. Policy reform will be required to transition from trade-based taxes to income and consumption taxes.

Bangladesh remains highly reliant on trade-related taxes, more so than peer countries. The country is preparing to graduate from LDC status in 2026. Through its National Tariff Policy (2023), it has committed to reducing the current high levels of protectionist tariffs and para-tariffs, which will promote international trade but can reduce trade-related taxes in the short term. This is an opportunity to move towards a tax structure consistent with an upper middle-income country, by reducing the current reliance on indirect taxes and expanding direct taxes. A tax structure aligned with that of competitors, coupled with an improved business climate, can gradually reduce the necessity of maintaining large tax expenditures to attract investment.

Recent Developments

Context

Bangladesh's post COVID-19 pandemic recovery faces continued headwinds. Stable macroeconomic conditions and strong export performance underpinned average real GDP growth of 6.6 percent over the decade leading up to the COVID-19 pandemic. Growth remained positive during the pandemic due to a fiscal stimulus program and accommodative monetary policies. However, in FY23, economic conditions worsened as inflation accelerated and the balance of payments deficit widened. The introduction of a multiple exchange rate regime in September 2022 led to a financial account deficit, and foreign exchange rationing measures were implemented to compress imports, resulting in electricity blackouts to conserve energy related imports. Increasing vulnerabilities in the financial sector have dampened future growth prospects.

Real Sector

Real GDP growth slowed to a 13-year low of 5.8 percent in FY23 — the lowest excluding the pandemic year in FY20 — due to a weakening of private consumption and investment which underpinned the contraction in the trade deficit as the decline in imports outweighed the slowdown in exports. Inflation dampened consumption growth, fueled by increased electricity and fuel prices, shortages stemming from import restrictions, and the depreciation of the taka. These factors combined with rising borrowing costs have resulted in weaker growth in the industrial sector. The erosion of consumer purchasing power has contributed to a slowdown in services growth as well.

The global economic outlook is subdued and Russian Federation's invasion of Ukraine and the conflict in the Middle East have elevated geopolitical risks.[1] Globally, inflation has moderated, and monetary tightening has paused, but growth prospects are expected to moderate in 2024 due to elevated real interest rates, risks of fiscal and financial stress, and a contraction in global trade in goods observed in 2023. Growth in advanced economies and China is expected to moderate in 2024, but growth in EMDEs with strong macroeconomic fundamentals is expected to improve (Table 1). The geopolitical uncertainty resulting from Russian Federation's invasion of Ukraine and the Middle East conflict has contributed to downside risks including potential negative impacts on commodity and oil prices and further disruptions to international trade. Uncertain global growth prospects coupled with persistent trade-related and geopolitical uncertainties mean that EMDEs like Bangladesh that rely heavily on the readymade garments (RMG) sector and commodity imports need to expedite structural reforms to bolster economic diversification to strengthen resilience of their economy to external shocks.

Table 1: Global Growth and Commodity Prices (Real GDP Growth (%))

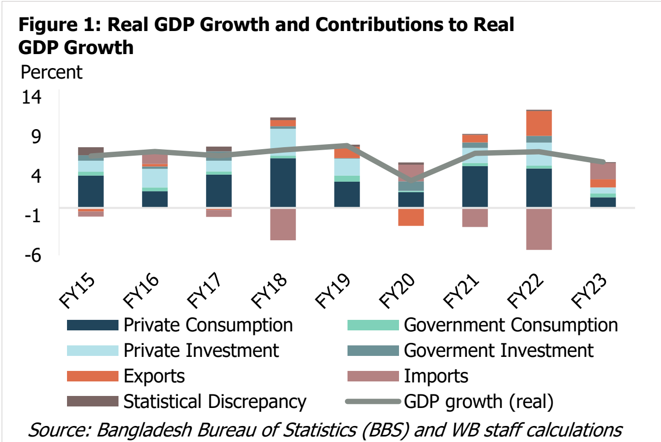
	2021	2022	2023e	2024f	2025f
World	6.2	3.0	2.6	2.4	2.7
Advanced Economies	5.5	2.5	1.5	1.2	1.6
USA	5.8	1.9	2.5	1.6	1.7
Euro Area	5.9	3.4	0.4	0.7	1.6
EMDEs	7.0	3.7	4.0	3.9	4.0
Commodity Prices					
Crude Oil, Brent ($/bbl)	70.4	99.8	84.0	81.0	80.0
Coal, Australia ($/mt)	138.1	344.9	175.0	130.0	110.0
Liquified Natural gas, Japan ($/mmbtu)	10.8	18.4	14.0	13.0	14.0
Fertilizer, TSP ($/mt)	538	716	480	400	350
Cotton ($/kg)	2.2	2.8	2.1	2.2	2.2
Iron ore ($/dmt)	161.7	121.3	108.0	105.0	100.0
Soybean oil ($/mt)	1385	1,667	1,120	1,105	1,095

Source: Global Economic Prospects (January 2024); and Commodity Markets Outlook (October 2023)

[1] World Bank, 2024. Global Economic Prospects, January 2024.

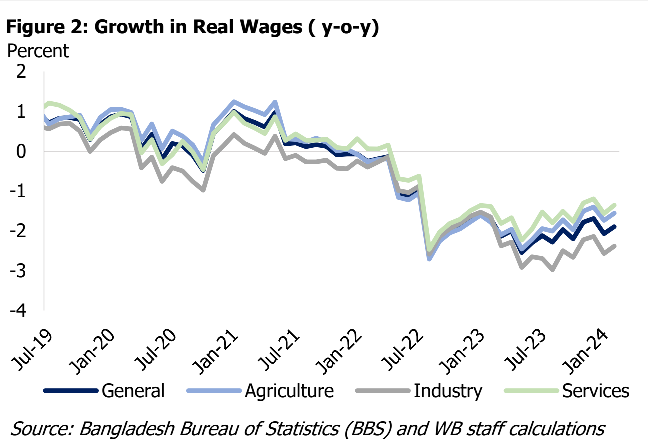
On the demand side, weaker private consumption and investment led to a decline in real GDP growth to 5.8 percent in FY23. The contribution of private consumption and investment to growth declined by 3.7 and 2.2 percentage points in FY23 (Figure 1). Rising inflation eroded consumer purchasing power, with a persistent decline in real wages since mid-2022 (Figure 2). Weak demand and import compression measures resulted in an 8.6 percent contraction in consumer goods imports in FY23, and a further 17.3 percent decline in the first seven months of FY24. Consumer credit growth declined from 26.7 percent in September 2022 to 16 percent in September 2023, and credit card issuance by banks declined in FY23 (BB, January 2024). Investment growth slowed because of political uncertainties, import restrictions, energy shortages, and increased cost of capital goods as the taka depreciated. Imports of intermediate and capital goods declined by 19.9 and 17.2 percent respectively in FY23 and remained depressed in the first seven months of FY24. Public investment slowed with only 31.1 percent of the Annual Development Plan implemented in the first eight months of FY24.

Figure 1: Real GDP Growth and Contributions to Real GDP Growth



Source: Bangladesh Bureau of Statistics (BBS) and WB staff calculations

Figure 2: Growth in Real Wages (y-o-y)



Source: Bangladesh Bureau of Statistics (BBS) and WB staff calculations

Industrial and service sector growth declined on the supply side. Import curbs leading to disruptions in the availability of key raw materials and capital goods coupled with shortages in the supply of gas and electricity led to a moderation in industrial growth from 9.9 percent in FY22 to 8.4 percent in FY23. In the first half of FY24 (July-December 2023), the index of industrial production (IIP) contracted 3.7 percent year-on-year driven by a decline in manufacturing of a wide range of products, including textiles, pharmaceuticals, motor vehicles, and transport equipment. Weak private consumption contributed to slower growth in services, declining from 6.3 percent in FY22 to 5.4 percent in FY23. The number of new companies registered declined to 4,516 from July to December FY24, compared to 8,314 over the same period in FY23.[2] Agricultural growth increased modestly from 3.1 in FY22 to 3.4 percent in FY23, supported by favorable weather conditions and higher market prices.

[2] Office of the Registrar of Joint Stock Companies and Firms. https://roc.portal.gov.bd/site/page/2f14b592-33c7-4931-b276-e16b0a9ded0d.

Table 2: Growth Rate (Real, percent)								
	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23
GDP Growth	**7.1**	**6.6**	**7.3**	**7.9**	**3.4**	**6.9**	**7.1**	**5.8**
			Growth (%)					
Industry	14.3	8.3	10.2	11.6	3.6	10.3	9.9	8.4
Services	7.0	6.4	6.6	6.9	3.9	5.7	6.3	5.4
Agriculture	-5.8	3.2	3.5	3.3	3.4	3.2	3.1	3.4
			Growth (%)					
Consumption	**3.4**	**6.3**	**9.1**	**5.5**	**2.9**	**7.9**	**7.4**	**2.5**
Private consumption	3.0	6.3	9.4	4.9	3.0	8.0	7.5	2.0
Government consumption	8.4	7.2	5.3	13.4	2.0	6.9	6.2	8.5
Investment	**9.0**	**8.4**	**12.1**	**6.9**	**3.9**	**8.1**	**11.7**	**2.2**
Private Investment	10.3	5.7	14.5	8.6	0.2	7.8	11.8	2.9
Government Investment	4.5	17.9	4.3	0.7	18.2	9.1	11.1	0.0
Resource Balance	**-31.8**	**33.1**	**76.4**	**-18.9**	**3.4**	**27.0**	**34.2**	**-38.4**
Exports, goods & services	2.2	-1.8	6.1	11.5	-17.5	9.2	29.4	8.0
Imports, goods & services	-7.1	5.2	23.9	0.5	-11.4	15.3	31.2	-9.8
Statistical discrepancy	**30.5**	**115.6**	**31.5**	**18.9**	**19.4**	**7.5**	**10.8**	**7.1**

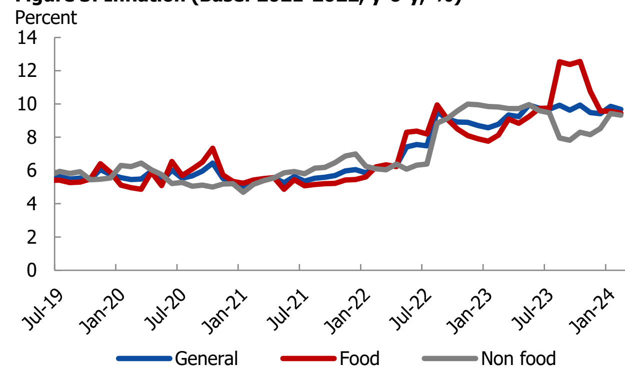
Source: Bangladesh Bureau of Statistics (BBS).

A contraction in imports outweighed a moderation in export growth. Real merchandise imports contracted by 9.8 percent in FY23 driven by a fall in intermediate, capital goods and, consumer goods. Over the first seven months of FY24, merchandise import payments in US dollars declined by 18.3 percent compared to the same period of FY23. The contraction resulted from foreign exchange shortages, weak consumer sentiment, and slowing private investment. Real merchandise export growth moderated to 8.7 percent in FY23, from 29.4 percent in FY22, driven by a contraction in home textiles, leather products, frozen food, engineering goods, and agricultural products. RMG exports increased by 10.3 percent. Merchandise export growth in nominal US dollars was tepid at 3.7 percent (y-o-y) in the first seven months of FY24. Bangladesh's export basket remains highly concentrated, particularly in terms of commodities. RMG accounted for 84.6 percent of exports in FY23, with a declining share of engineering, agriculture, jute, frozen food, and leather goods in recent years.

Inflation

Inflation remained elevated, with contributions from both external and domestic factors. Given Bangladesh's dependence on imports of key commodities, especially wheat, edible oil, fertilizers and chemicals, petroleum products, yarn and cotton, inflation started to accelerate around February 2022, coinciding with the supply chain disruptions resulting from Russia's invasion of Ukraine. Inflation has remained elevated even as international prices of many of these commodities eased in FY23 (Table 1). Headline CPI inflation has remained above 9 percent since August 2022, driven by persistently rising food and non-food prices (Figure 3). Continued shortages of foreign exchange resulting in curtailment of key imports, depreciation of the taka against the US dollar, increases in the domestic administered prices of gas, electricity, and petroleum products offset lower international commodity prices. Expansion in domestic credit with monetization of the fiscal deficit contributed to persistent demand pressures.

Figure 3: Inflation (Base: 2021-2022, y-o-y, %)



Source: Bangladesh Bureau of Statistics

Bangladesh faces a trade-off between inflation and growth in the short term. Inflation expectations are not anchored at a credible target and are estimated to have increased sharply starting FY22 (IMF, 2023). Persistent

and well calibrated monetary tightening coupled with fiscal consolidation will help to anchor inflation expectations and rein in inflation over the medium term. However, since domestic economic activity remains weak, these actions can entail significant output costs.

Poverty and welfare

Economic growth supported a continued reduction in poverty and improving living conditions. Between 2016 and 2022, poverty declined by 1.3 percentage points annually from 26.5 percent to 18.7 percent, lifting 11 million people out of poverty (using the national upper poverty line [UPL]). By 2022, less than one in five Bangladeshis were classified as poor (18.7 percent using the national UPL), with less than six percent living in extreme poverty (using the lower national poverty line [LPL]). This indicates a continuation of the positive trajectory observed since 2010 when poverty stood at 37.1 percent and decreased to 26.5 percent by 2016 (using the national UPL). Welfare improvements were observed across the income distribution, with 5.4 million individuals transitioning from extreme poverty to moderate poverty between 2016 and 2022. Although many still fall within the moderately poor category, there have been notable improvements in their living conditions, suggesting progress towards overcoming poverty.

Non-monetary dimensions of well-being have improved. There are substantial positive outcomes in infant mortality, stunting, access to electricity, sanitary toilets, and education. Between 2017 and 2022, infant mortality declined from 36 to 25 deaths per 1,000 births, and the proportion of children under five years of age who remain stunted fell from 31 percent in 2017 to 24 percent in 2022 (DHS, 2022). Access to electricity was almost universal in 2022, with an impressive 22-percentage point growth since 2016. The percentage of households with sanitary toilets increased significantly from 25.6 percent in 2016 to 40.1 percent in 2022. Literacy rates for adults increased by nearly ten percentage points from 62.5 in 2016 to 72.3 percent in 2022. Labor force participation increased in the agricultural sector between FY17 and FY22, but it declined in the industrial and service sectors.[1] Female labor force participation also increased from 36.3 percent to 42.7 percent over this period.

There are contrasting narratives of progress between rural and urban Bangladesh. Consumption growth lifted all Bangladeshi welfare levels between 2016 and 2022. However, consumption growth is more evenly distributed among rural households than urban households. Thus, poverty reduction in rural areas was faster (from 29.1 to 20.5 percent, using the UPL) than in urban areas (from 19.4 to 14.7 percent). A quarter of all the poor in the country live in urban areas. Even though the consumption Gini index decreased in rural areas (30.1 to 29.1), it increased in urban areas (33.8 to 35.6). The opposing trends in inequality between urban and rural areas counterbalanced each other, leading to a nearly unchanged level of national inequality in 2022. There are signs of convergence in the welfare gap between eastern and western Bangladesh, with poorer western regions playing a crucial role in this robust poverty reduction progress. However, the welfare differences are still significant, with the Eastern regions having higher welfare compared to the Western regions.

The welfare of the displaced Rohingya population (DRP) is deteriorating because of declining external assistance. The DRP depends on external assistance for approximately 70 percent of their consumption. The Bangladeshi Host Communities (HC) and DRP rely on support from other DRP in the camp or aid to secure food (45 percent of the HC and 58 percent of the DRP). Data from the second round of the Cox's Bazar Panel Survey (2023) show that after the first cuts to World Food Program (WFP) assistance in early 2023, over one-third of Rohingya households resorted to eating less of their preferred food, with 15 percent restricting adult food consumption and 23 percent reducing portion sizes. Food insecurity and child malnutrition are expected to worsen

[1] Based on a provisional BBS report on the 2022 Quarterly Labour Force Survey (QLFS).

following additional recent cuts to WFP food assistance. Employment prospects have seen a modest uptick since 2019, primarily through voluntary work within the camps and agriculture for the DRP and HC. Despite this, a striking 69 percent of Rohingya youth (41 percent for males and 93 percent for females) remain disengaged from education, employment, or training, reflecting limited opportunities within the camps. Job scarcity affects HC and DRP communities, exacerbating economic vulnerabilities.

Monetary and Financial Sector Developments

Bangladesh Bank (BB) continued to tighten monetary policy in FY24, to slow inflation. It introduced an interest targeting framework over the past year. However, monetary policy transmission remains impaired by a variable cap on bank lending rates. While the policy rate has risen by a cumulative 325 bps, real interest rates remain negative. Public sector credit growth moderated in FY24, with less reliance on the banking system to finance the deficit. Liquidity within the banking system has tightened due to unsterilized BB foreign exchange sales and weak deposit growth. Private sector credit slowed in FY24, largely reflecting the decline in imports due to forex shortages. To address elevated banking sector vulnerabilities, BB has proposed bank mergers and introduced a Prompt Corrective Action (PCA) framework.

Table 3: Monetary Program Performance

	FY20	FY21	FY22	FY23	FY 24	
	Actual	Actual	Actual	Actual	Target (Jun-24)	Actual (Dec-23)
Net Foreign Assets	10.2	27.7	-11.9	-23.4	4.7	-21.8
Net Domestic Assets	13.4	9.3	17.2	21.3	11.1	16.2
Domestic credit	13.7	10.4	16.2	15.3	15.4	11.7
Public Sector credit	53.4	21.7	29.1	35.8	31.0	18.0
Private Sector credit	8.6	8.3	13.7	10.6	11.0	10.2
Broad Money	12.7	13.6	9.4	10.5	10.0	8.8
Reserve Money	15.7	22.4	-0.3	10.5	6.0	-2.0
Inflation (end of period average)	5.6	5.6	6.1	9.0	7.5	9.7
Real GDP Growth	3.4	6.9	7.1	5.8	6.5	6.0*

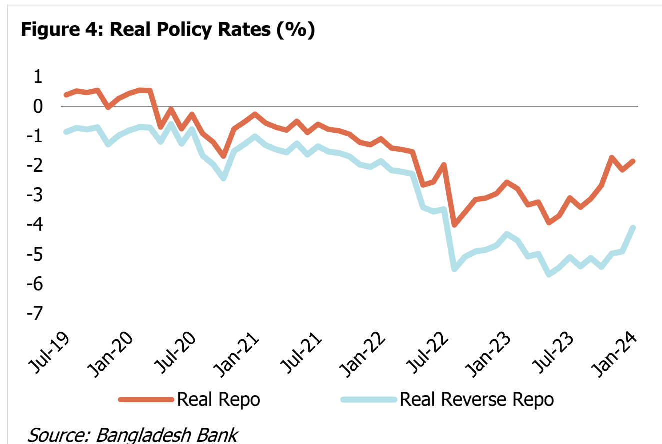
*Source: Bangladesh Bank and Bangladesh Bureau of Statistics. *FY24, Q1 provisional GDP growth*

BB is transitioning from monetary targeting to an interest rate targeting framework with the introduction of an Interest Rate Corridor (IRC) and variable lending rate cap. The new framework focuses on the repo rate as the primary target of monetary policy while moving away from reserve money targeting. In July 2023, the BB introduced an IRC centered around the repo rate with the upper and lower limits of the corridor set by the Standing Lending Facility (SLF) and the Standing Deposit Facility (SDF) rates. Intended to signal BB's monetary stance more effectively, driving short-term interest rates, the IRC is designed to ensure that the short-term interbank call money rate remains range bound and around the policy rate. In July 2023, BB introduced a variable "six-month moving average rate of treasury bills" (SMART) reference rate. Major categories of bank lending rates are limited to a fixed spread above the SMART rate. This variable lending rate cap replaced a 9 percent fixed rate lending cap. The BB also removed a floor on deposit rates.

BB tightened monetary policy further in FY24, but transmission has been dampened by the SMART lending rate cap. The repo rate has been cumulatively tightened by 325 basis points since May 2022 to 8 percent by March 2024. Liquidity conditions in the domestic market have tightened substantially due to unsterilized US dollar sales by BB, weak deposit growth, and elevated non-performing loans. The interbank call money rate for overnight bank lending increased to 8.7 percent by March 2024 from 6 percent a year earlier. Monetary policy transmission is hindered by the SMART lending rate cap, which slows pass-through to lending rates due to the use of a moving average. The use of treasury bills for the reference rate, rather than the policy rate, further complicates pass-through. The real policy rate and deposit rates remain negative, while the weighted average lending rate is approaching the inflation rate (Figure 4 and Figure 5). The real interest rate on new lending at or near the SMART

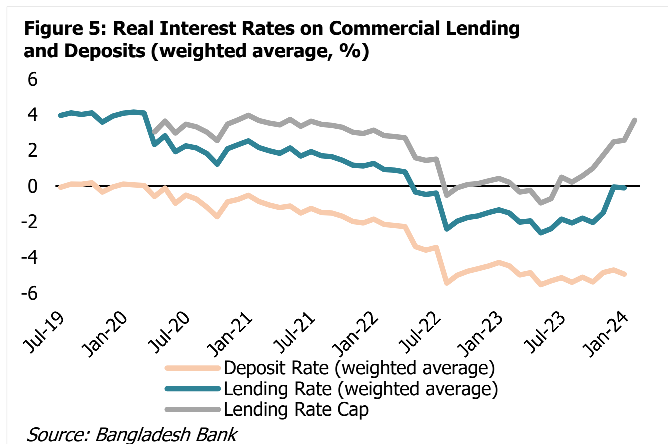
rate plus the maximum margin interest (currently 3.5% above SMART) has turned positive. The advance-to-deposit ratio (ADR) stood at 80.4 percent at the end of 2023, significantly below the regulatory limit of 87 percent set for conventional banks.

Figure 4: Real Policy Rates (%)



Source: Bangladesh Bank

Figure 5: Real Interest Rates on Commercial Lending and Deposits (weighted average, %)

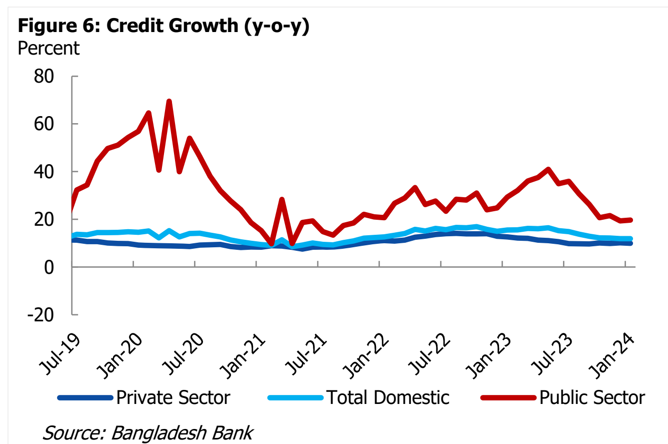


Source: Bangladesh Bank

Money supply growth accelerated marginally in FY23 but has moderated in FY24 and remains below the BB target. Broad money growth rose marginally to 10.5 percent in FY23. Net sales of foreign exchange by BB led to a 13.0 percent decline in Net Foreign Assets (NFA). This was offset by a nearly 17 percent increase in Net Domestic Assets (NDA) because of increased monetization of the fiscal deficit by the government. From July to February FY24, NFA declined by 15.1 percent as foreign exchange sales continued. However, NDA growth slowed, and broad money growth fell marginally to 8.6 percent. The growth in money supply thus remains below the target of 10 percent announced by the BB in the January-June 2024 Monetary Policy Statement (MPS).

Private and public sector credit growth moderated further in FY24. Tight domestic liquidity conditions, high inflation, and uncertainty related to exchange rate policies weighed on private investment. Growth in total domestic credit moderated to 15.3 percent in FY23 from 16.2 percent in FY22. This was led by a sharp deceleration in private sector credit growth to 10.6 percent in FY23, down from 13.7 percent in the previous year. Public sector credit growth increased to 34.9 percent in FY23 from 27.2 percent in FY22, due to deficit financing from banks. In the first seven months of FY24, credit growth moderated to 11.9 percent driven by a slowdown in private sector credit growth (Figure 6). Public sector credit growth slowed with a shift in the domestic composition of borrowing by BB to commercial banks. Rates on government treasury bills have risen significantly as a result.

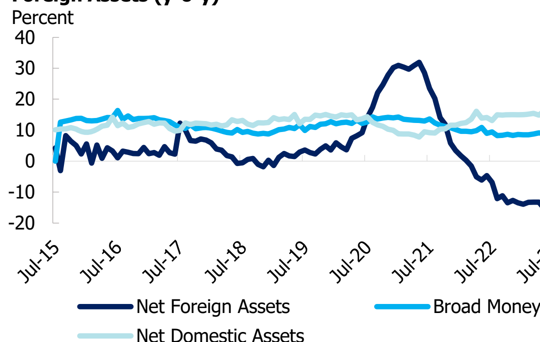
Figure 6: Credit Growth (y-o-y)



Source: Bangladesh Bank

Stressed assets in the banking sector continue to rise. Officially recognized non-performing loans (NPL) increased by 20.7 percent year-on-year at the end of December 2023 compared to the previous year. The gross NPL ratio (ratio of NPLs to total loans) stood at 9 percent in December 2023 compared to 8.2 percent in December 2022. The NPL ratio understates banking sector vulnerabilities due to lax regulatory definitions and reporting standards, repeated forbearance measures, and weak regulatory enforcement. Loan loss provisions stood at 54.7 percent of NPLs at the end of December 2023, improving slightly compared to the last quarter, but worsening compared to the same period of last year. NPLs are concentrated in state-owned banks, which accounted for nearly 45.4 percent of the total. A broader measure of stressed assets was presented in the 2022 Financial Stability Report, published in August 2023. Total non-performing loans, rescheduled loans, and outstanding written-off loans reached BDT 3,779.2 billion (US$ 34.7 billion, 9.5 percent of FY22 GDP, and 25.6 percent of total outstanding loans) by the end of 2022. BB has also reduced the period of NPL write-off from three years after a loan becomes bad/loss to two years to clean the stock of NPLs from bank balance sheets.

Figure 7: Broad Money, Net Domestic Assets, and Net Foreign Assets (y-o-y)



Source: Bangladesh Bank

Tight liquidity conditions in the banking system persisted. BB continued to provide liquidity support to banks, particularly to the Shariah-based banks, often with limited collateral requirements. Overnight and two-week interbank interest rates increased due to tighter liquidity conditions, rising from 7.5 and 7.25 percent in March 2023 to 9.5 and 11.75 percent in March 2024. The advance-to-deposit ratio increased to 80.4 percent at the end of 2023 from 79 percent at the end of 2022. Yields on government securities are also increasing. The yield on 6-month treasury bills rose to 11.38 percent in March 2024 while 10-year treasury bonds yielded over 12 percent in February 2024. This is higher compared to the SMART reference rate of 9.6 percent in March 2024.

BB proposed new measures to address rising vulnerabilities. Authorities announced an NPL resolution roadmap in February 2024, which followed 2023 amendments to the Bank Company Act (1991). New measures in the roadmap will identify willful defaulters of bank loans and enforce sanctions such as restrictions on travelling abroad, obtaining trade licenses, and company registration that are to be effective from July 1, 2024. Strong political will is necessary to enforce these measures. Further, a legal framework would be needed to manage the stock of distressed loans.

BB has set out a framework for corrective actions to manage weak banks and announced plans to merge weak banks with strong banks. BB issued a circular on the Prompt Corrective Action (PCA) framework in December 2023 to address weak banks, which will be effective from March 31, 2025. Under the PCA framework, banks will be categorized into four groups. In cases of non-compliance with PCAs or non-achievement of targets, the weakest banks may be subject to resolution measures. In March 2024, BB announced plans to merge weak banks with strong banks, EXIM Bank and Padma Bank signed a letter of intent to merge, initiating the first merger process. Proceeding with forced mergers without a thorough assessment of asset quality may be counterproductive (see Outlook, Risks, and Reform Priorities, page21).

Despite several policy changes, investor confidence in the capital market remained subdued. The Bangladesh Securities and Exchange Commission withdrew floor prices on equities in January 2024, which had been a major market distortion. The Dhaka Stock Exchange broad index rose by 0.6 percent (y-o-y) in February 2024. Over the past six months, there were four Initial Public Offerings totaling BDT 5.6 billion—a closed-end mutual fund sized

at BDT 2 crore, two companies on the SME board with a combined size of BDT 0.10 billion, and 4 perpetual bonds by various banks amounting to BDT 17 billion.

External Sector

The Current Account Deficit (CAD) narrowed in FY23 and moved into surplus in the first seven months of FY24, driven by import suppression measures. However, the financial account turned into deficit, due to a persistently growing outflow of trade credits and other short-term loans. As a result, the Balance of Payments (BoP) deficit widened to US$ 8.2 billion in FY23 and US$ 4.7 billion in the first seven months of FY24. Exchange rate flexibility was insufficient to clear the foreign exchange (FX) market. BB sold US dollars at an accelerated rate. Gross FX reserves declined by US$ 4.0 billion so far in FY24, reaching US$ 20.8 billion in February 2024.

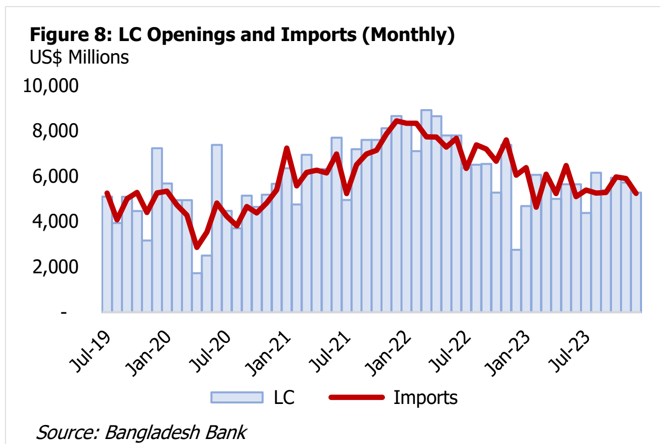
Table 4: Balance of Payments

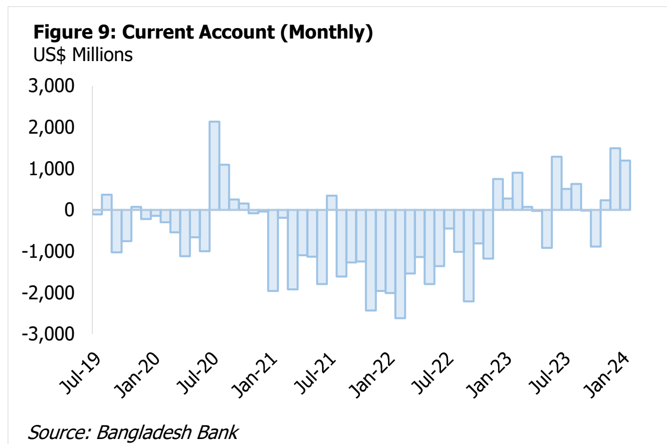
US$ millions

	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24 (Jul-Jan)
Overall Balance	**3,169**	**-857**	**179**	**2,925**	**9,274**	**-6,656**	**-8,222**	**-4,684**
Current account balance	**-1,331**	**-9,567**	**-4,490**	**-4,723**	**-4,575**	**-18,196**	**-2,665**	**3,148**
Trade balance	-9,472	-18,178	-15,835	-17,858	-23,778	-33,250	-17,163	-4,628
Merchandise export f.o.b. (inc. EPZ)	34,019	36,285	39,604	32,832	36,903	49,245	52,332	31,398
Merchandise import f.o.b. (inc. EPZ)	-43,491	-54,463	-55,439	-50,690	-60,681	-82,495	-69,495	-36,026
Services	-3,288	-4,201	-3,176	-2,541	-3,020	-3,987	-4,384	-2,767
Income	-1,870	-2,641	-2,382	-3,106	-3,172	-2,726	-3,407	-2,713
Current transfers	13,299	15,453	16,903	18,782	25,395	21,767	22,289	13,256
Official	59	51	41	19	51	65	88	23
Private	13,240	15,402	16,862	18,763	25,344	21,702	22,201	13,233
o/w Workers' remittance	12,769	14,982	16,420	18,205	24,778	21,032	21,611	12,901
Capital account	**400**	**331**	**239**	**256**	**458**	**610**	**475**	**162**
Financial account	**4,247**	**9,011**	**5,130**	**7,537**	**14,067**	**16,691**	**-2,078**	**-7,354**
Foreign direct investment (net)	1,653	1,778	2,628	1,271	1,355	1,827	1,649	901
Portfolio investment (net)	457	349	171	44	-269	-158	-30	-107
MLT loans (excludes suppliers' credit)	3,218	5,987	6,263	6,222	7,449	10,295	8,704	4,380
MLT amortization payments	-895	-1,113	-1,202	-1,257	-1,417	-1,527	-1,745	-1,155
Other long-term loans (net)	-153	141	302	438	1,684	1,443	-434	392
Other short-term loans (net)	1,030	1,508	272	931	2,064	3,315	-1,883	-1,359
Trade Credit (net)	-1,185	-1,270	-3,493	-616	3,749	311	-6,436	-9,222
Change in Commercial Bank Assets (net)	122	1,631	189	-270	-548	1,185	-2,771	-1,184
Errors and omissions	**-147**	**-632**	**-700**	**-145**	**-676**	**-5,761**	**-3,954**	**-640**

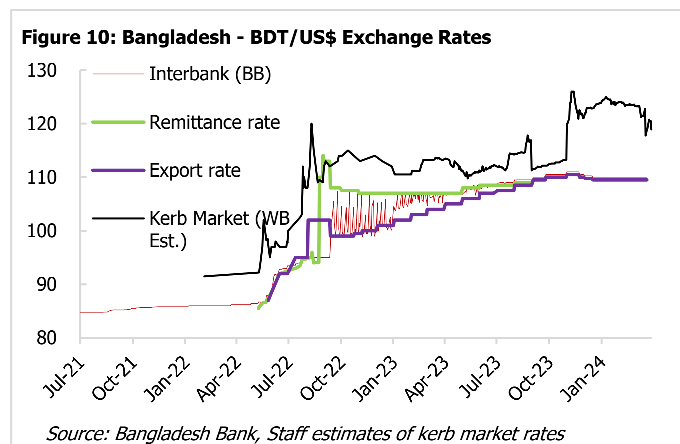
Source: Bangladesh Bank.

The current account moved into surplus in FY24, driven by a substantial contraction in imports. The CAD moderated to US$ 3.3 billion in FY23, down from US$ 18.6 billion in FY22, as intermediate and capital goods drove a 15.8 percent decline in imports. Merchandise exports grew by 6.7 percent, led by a 10.3 percent increase in RMG exports. In the first seven months of FY24, the current account moved into a US$ 3.1 billion surplus. Imports contracted 18.2 percent over this period, significantly higher than the contraction witnessed over the same period of FY23 because of restrictions on letters of credit (Figure 8). Export growth moderated to 0.8 percent with RMG export growth slowing to 1.7 percent (Figure 9). Recovery in inflows of remittances via official channels from October 2023 onwards contributed to the current account moving into surplus.





The balance of payments remained in deficit in the first seven months of FY24, led by the financial account. The BoP deficit persisted, although it narrowed from a US$ 7.4 billion deficit over the same period of FY23 to US$ 4.7 billion. The financial account deficit widened to US$ 7.3 billion over July-January FY24 compared to US$ 0.9 billion over the same period of FY23. This was driven by a decline in short-term lending, led by net trade credit. Trade credit contracted because of deferred repatriation of export earnings, as well as continuing import restrictions. In FY23, for example, export payments were approximately US$ 12 billion below total export shipments. Other short-term lending contracted because of higher US interest rates and deteriorating private sector creditworthiness. Medium and Long Term (MLT) loans were constrained by sluggish implementation of infrastructure projects. Net Foreign Direct Investment (FDI) declined over July-January FY24 from a low baseline. The contribution of net errors and omissions to the BoP deficit has moderated.



Exchange rate adjustments remained insufficient to clear the FX market, putting pressure on foreign reserves. Formal exchange rate caps converged in September 2023, following the elimination of a lower rate for the sale of BB foreign exchange reserves and unification of Bangladesh Foreign Exchange Dealers Association (BAFEDA) caps on remittance and export inflows. The export and remittance rate cap were set at 110.5 BDT/US$ in September 2023, and were appreciated to 109.5 BDT/US$ subsequently. The interbank exchange rate has been insufficiently flexible to clear the FX market, resulting in acute dollar illiquidity in domestic banks. In November 2023, BAFEDA allowed banks to purchase remittance inflows above the formal cap by providing additional incentive payments, and BB has allowed deviations from the remittance exchange rate cap through verbal instructions to individual banks. This has resulted in the reemergence of a de facto multiple exchange rates and the divergence of the interbank and kerb market exchange rates. By mid-March 2024, the kerb market rate reached 120.5 BDT/US$ compared to the 110.0 BDT/US$ interbank exchange rate cap.

Continued BB FX sales have led to a decline in reserves. Gross reserves declined to US$ 20.8 billion by February 2024, representing 3.3 months of import coverage. To move towards a more flexible exchange rate, BB announced

in its January to June 2024 MPS that it is, "contemplating the implementation of a crawling peg system." However, the timeline for implementation and a technical methodology have not been announced.

Box 1: Policies Adopted to Preserve FX Reserves
BB has taken several steps to stem the depletion of the FX reserves, in addition to import restrictions: • *Reducing the size of the Export Development Fund (EDF) and implementing stringent eligibility criteria:* The EDF uses foreign exchange reserves to provide trade finance. Newly adopted BPM6 standards exclude the EDF from gross reserves. BB has reduced the EDF by US$ 2.6 billion to US$ 4.6 billion as of July 2023.[3] The ceiling for loans from EDF for individual exporters has been reduced to US$ 10 million from US$ 15 million. To accelerate repayments to the facility, a 4 percent interest penalty will be charged to banks on overdue EDF loans and may be debited from foreign currency clearing accounts that the banks maintain with BB. • *Ensuring timely receipt of export earnings:* Rules have been tightened to prevent delayed repatriation of export earnings by exporters anticipating further depreciation in administered exchange rates. According to BB rules, exporters are required to repatriate export proceeds within 120 days of shipment. BB announced a new policy that would require banks to provide exporters with the exchange rate applicable on the day when export proceeds should have been realized regardless of when the export earnings are repatriated, to discourage deferral of repatriation for more favorable exchange rates. • *Providing flexibility to banks for transferring capital between their offshore and domestic units:* Banks are now permitted to transfer up to 40 percent of their total regulatory capital from their offshore banking units (OBS) to their domestic units for settling import payments, an increase from the previous limit of 25 percent.

Fiscal Trends and Debt Sustainability

Tax collection grew by 13.9 percent in the first half of FY24, driven by domestic direct and indirect taxes, but Bangladesh's revenue to GDP ratio remains one of the lowest in the world, at 8.2 percent of GDP in FY23 and projected at 8.6 percent for FY24. Expenditure growth remained modest due to the ongoing austerity measures and deferral of lower-priority public investment projects. The fiscal deficit is estimated to have narrowed marginally in FY23 to 4.4 percent of GDP. Net borrowing from the banking sector declined. Public debt as a share of GDP increased but remains sustainable.

Tax collection growth was robust in the first half of FY24. After a moderate decline in FY23, tax collection rose by 13.9 percent in the first half (July-December 2023) of FY24 compared to the previous fiscal year. The growth was driven by a 16.0 percent increase in direct taxes and a 13.9 percent increase in domestic indirect taxes. However, growth in trade-related taxes remained moderate due to the fall in imports. Non-tax revenue, which usually contributes around 10 percent of total revenue, rose significantly by 64.5 percent in the first quarter of FY24 driven by an increase in several fees and charges of government services. As in previous years, the National Board for Revenue (NBR) set an ambitious target of BDT 4300 billion for taxes in FY24 (22.0 percent higher than the provisional FY23 collection). Despite the robust growth of revenues, only 40 percent of the revenue target for FY24 was achieved in the first half of the fiscal year. Bangladesh's revenue-to-GDP ratio remained one of the lowest in the world at 8.2 percent in FY23.

[3] The EDF provides financing in foreign currency for input procurements by manufacturer-exporters. The central bank disburses the fund from FX reserves through authorized dealer banks. The size of the EDF was increased to US$ 7 billion during the COVID-19 pandemic.

Table 5: Fiscal Outcomes (% of GDP)							
	FY18	FY19	FY20	FY21	FY22	FY23	FY24e
Total revenue 1/	8.2	8.6	8.5	9.4	8.5	8.2	8.6
Tax revenue	7.4	7.7	7.0	7.6	7.5	7.3	7.5
Total expenditure	12.2	13.3	13.3	13.0	13.0	12.6	13.2
Current expenditure	6.8	7.4	7.4	7.5	7.7	7.8	8.3
Capital expenditures	4.7	5.2	5.1	4.7	4.6	4.6	4.6
Deficit 1/	-4.0	-4.7	-4.8	-3.7	-4.6	-4.4	-4.6
Net external financing	1.0	1.1	1.3	1.3	1.6	1.7	1.8
Net domestic financing	3.0	3.6	3.4	2.3	2.9	2.6	2.8
General government debt stock	27.2	28.5	31.7	32.4	33.7	35.0	35.0
External	10.4	10.4	11.8	11.9	12.4	12.9	12.9
Domestic	16.8	18.1	19.9	20.5	21.3	22.1	22.0

Source: Ministry of Finance.
1/Excluding grants

Total expenditure growth remained modest. Total expenditure grew modestly by 1.5 percent in the first quarter (July-September 2024) of FY24. Expenditure growth in goods and services was constrained by ongoing austerity measures. Capital expenditures were hampered by difficulties in imports because of the foreign exchange shortages and reprioritization of projects. Growth in subsidies, incentives, and transfers moderated after a surge in FY23. Based on a recent study by the NBR, tax expenditures for direct taxes were 3.5 percent of GDP in FY21. Implementation of the Annual Development Program (ADP) remained low at 31.1 percent in the first eight months (July-February) of FY24, compared to 34.9 percent in the previous year.

The government has adopted policies to reduce subsidy payments and clear arrears. To reduce subsidy payments over the medium term, the government cut export subsidies to almost all sectors, increased prices of electricity, and adopted a market-linked pricing formula for liquid fuels in line with global prices. A formula-based fuel pricing system was introduced in March 2024, which will result in monthly adjustments of prices of diesel, petrol, octane, and kerosene in line with international market prices. In the initial price adjustment, retail prices declined modestly, reflecting lower international energy prices. This pricing mechanism will reduce explicit fiscal subsidies on covered fuel types as a result of changes in international prices. To resolve arrears to fertilizer suppliers and independent power producers, the government issued a series of special bonds at below-market interest rates. As of February 2024, the special bond issuance reached BDT 53.7 billion. Bonds purchased by domestic banks will count towards statutory liquidity ratio requirements and will be eligible for BB repo facilities. This risks de facto deficit monetization, which could offset BB's contractionary monetary policy stance.

Several large public infrastructure projects became operational. After commencing operation partially in December 2022, all 16 stations of the Dhaka metro rail became operational in December 2023. After the opening of the road operations of the Padma Bridge in June 2022, the rail component of the bridge became operational in October 2023. The Bangabandhu Sheikh Mujibur Rahman Tunnel under the Karnaphuli River was also opened for use in October 2023, enhancing connectivity between Dhaka, Chattogram, and Cox's Bazar. The Uttara-Farmgate portion of the Dhaka Elevated Expressway opened for public use in September 2023 and additional ramps are expected to open soon. The first shipment of Uranium for the Rooppur Nuclear Power Plant, one of the largest projects under implementation, arrived from Russia in October 2023. However, the project's implementation has experienced additional delays.

The fiscal deficit is estimated to have narrowed marginally in FY23 to 4.4 percent of GDP. Deficit financing in FY23 predominantly depended on borrowing from the banking sector. In the first seven months (July-January) of FY24, a slowdown in spending on infrastructure projects narrowed the deficit substantially. Net borrowing from the banking sector turned negative at BDT 189.7 billion, while net borrowing from the non-banking sector rose to BDT 90.6 billion, up from BDT 38.0 billion over the same period of the previous year. Non-bank borrowing consists

of debt instruments held outside the banking system and remains far below the FY19-FY22 average (BDT 370.3 billion), when National Savings Certificates (NSC) were the primary source of domestic financing. NSC issuance remained negative in the first seven months of FY24 because of less competitive interest rates and tighter controls over NSC issuance. Under the borrowing plans under the FY24 budget, 85.1 percent of total domestic borrowing is expected to come from the banking sector for the full year. Net foreign financing rose by 19.6 percent (y-o-y) during the same period.

The stock of public debt continued to grow, but the risk of debt distress remained low. Estimated public debt (excluding guarantees) rose to 35.0 percent of GDP in FY23, from 33.7 percent in FY22. External debt amounted to 12.9 percent of GDP, mostly owed to multilateral creditors (53.8 percent of total external debt), although their share in overall external debt has been declining in recent years with increased borrowing from bilateral creditors to finance large infrastructure projects. About half of the external debt is denominated in US dollars, and Japanese Yen (21 percent) and Euro (17 percent) are the other two major currencies (Ministry of Finance, 2023). The December 2023 joint World Bank-IMF Debt Sustainability Analysis (DSA) assessed Bangladesh to be at low risk of debt distress, as in the past. The MoF is currently working towards updating their Medium-Term Debt Strategy.

Outlook, Risks, and Reform Priorities

GDP growth is projected to decelerate to 5.6 percent in FY24 and improve marginally to 5.7 percent in FY25, before reverting to its long-term trend. Inflation is likely to remain elevated in the near term and gradually subside if import prices stabilize, international commodity prices moderate and are passed through to domestic prices, and appropriately contractionary monetary and fiscal policies are maintained over the medium term. Pressure on the external sector is expected to persist in FY24, easing later if global conditions are favorable and if exchange rate flexibility improves. The fiscal deficit is expected to remain within the government's target of 5.0 percent of GDP, with fiscal space for productive expenditures increasing only gradually. There are significant downside risks. Failure to address distortions in the foreign exchange market, rising inflation, slowing demand in Bangladesh's major export markets, and intensifying financial sector vulnerabilities could lead to slower growth.

Near-term outlook, risks, and priorities

The global economy is set to recover only slowly, with risks tilted to the downside. Global growth is projected to slow to 2.4 percent in 2024, before recovering to 2.7 percent in 2025, which is below the average growth rate of 3.1 percent over the decade prior to COVID-19. Growth remains constrained by elevated interest rates, tight financial conditions, slowing trade, and subdued investments. Even though global inflation has moderated, it remains elevated in most countries. Russia's invasion of Ukraine and renewed conflict in the Middle East could lead to surges in energy prices with negative spillovers on global inflation and economic activity. With the recovery in advanced economies (AEs) slower than initially projected and growth in China projected to slow, the global economy is not expected to demonstrate significant dynamism in the near future.

The Bangladesh economy is expected to remain stressed in the near term. Real GDP growth is projected to decline to 5.6 percent in FY24, due to inflation weighing on private consumption growth, and shortages of energy and inputs, rising interest rates, and financial sector vulnerabilities dampening investor sentiment. Growth is projected to improve marginally to 5.7 percent in FY25 driven by a modest recovery in private consumption supported by a moderation in inflation and assistance provided by the government to provide subsidized food to vulnerable sections of the population. Investment is expected to be supported by improved implementation of large investment projects. On the supply side, this would be reflected in higher industrial growth, but services growth is expected to remain subdued. Growth is expected to increase gradually over the medium-term as inflationary pressures ease significantly, input and foreign exchange shortages are addressed through external sector reforms, and as a result investment sentiment improves.

Table 6: Selected Macroeconomic Indicators (annual percentage change, unless indicated otherwise)

	FY21	FY22	FY23	FY24e	FY25f	FY26f
Real GDP growth, at constant market prices	6.9	7.1	5.8	5.6	5.7	5.9
Private Consumption	8.0	7.5	2.0	1.4	4.9	5.3
Government Consumption	6.9	6.2	8.5	10.6	9.9	7.4
Gross Fixed Capital Investment	8.1	11.7	2.2	5.6	8.8	8.6
Exports, Goods, and Services	9.2	29.4	8.0	0.1	7.2	6.4
Imports, Goods, and Services	15.3	31.2	-9.8	-12.2	12.5	10.2
Real GDP growth, at constant factor prices	7.0	7.2	6.2	5.7	5.7	5.9
Agriculture	3.2	3.1	3.4	3.1	3.1	3.2
Industry	10.3	9.9	8.4	6.6	7.2	6.8
Services	5.7	6.3	5.4	5.6	5.1	5.8
Inflation (Consumer Price Index)	5.6	6.1	9.0	9.6	8.5	6.5
Current Account Balance (% of GDP)	-1.1	-4.0	-0.6	0.9	0.7	-0.2
Financial Account Balance (% of GDP)	3.4	3.6	-0.5	-1.4	-0.3	1.0
Fiscal Balance (% of GDP) 1/	-3.7	-4.6	-4.4	-4.6	-4.7	-4.8
Primary Balance (% of GDP) 1/	-1.7	-2.6	-2.5	-2.1	-2.2	-2.3
Debt (% of GDP)	32.4	33.7	35.0	35.0	35.3	36.3

Source: Bangladesh Bureau of Statistics; Ministry of Finance; Staff Estimates. 1/ including grants

Inflation is expected to remain elevated in the short term and decline only gradually thereafter. While the continued depreciation of the Taka, and curbs on the imports of consumer and capital goods due to persistent foreign exchange shortages will add to inflationary pressures. The linking of fuel prices with import prices introduced in March 2024 will allow for greater passthrough of international prices to domestic consumers. The first application of this formula resulted in a slight decline in domestic fuel prices. Headline inflation is expected to remain elevated at 9.6 percent in FY24 before moderating to 8.6 percent in FY25. However, the inflation trajectory depends crucially on the extent of transmission of BB's contractionary monetary policy and the government's fiscal policy stance.

BB has introduced measures to contain inflation, but a sustained moderation of inflation is expected to take place only gradually. BB has prioritized the containment of inflation as its main policy focus. Continued high inflation not only erodes purchasing power of consumers but can lead to entrenched expectations of higher inflation. BB has embarked on a path of contractionary monetary policy through continuous hikes in the policy rate to anchor inflationary expectations while undertaking steps to improve transmission. Amid tight liquidity conditions and slowing private sector credit, BB has enhanced the flexibility of interest rate caps and introduced an interest rate corridor to better signal its monetary stance. A sustained moderation in inflation and normalization of imports will take place only gradually as the recent measures introduced by BB are expected to impact the real economy with a lag.

Poor asset quality and the weak capital base of the banking system are hampering intermediation and monetary transmission. The gross NPL ratio stood at 9 percent in December 2023 compared to 8.2 percent in December 2022. The actual magnitude of the NPL problem is likely to be significantly higher due to the legacy of regulatory forbearance. Capital adequacy of the banking system stood at just 11.1 percent in September 2023, with at least a dozen banks severely undercapitalized for years despite capital injections. Inadequate bank capital is a significant factor constraining private credit and investment. Continued regulatory forbearance and weak credit risk assessment systems hamper the productive allocation of credit, thereby risking further deterioration in bank asset quality. Impaired bank balance sheets also prevent effective transmission of monetary policy as the incentives for weak banks to conduct intermediation in response to market signals remain limited. Implementation of the PCA framework and modern resolution and crisis management frameworks to identify the magnitude of the NPL problem and expedite its resolution are needed to reduce risks of financial instability and strengthen monetary policy transmission.

Forced bank mergers may be counterproductive without a thorough assessment of asset quality. A consolidation process will require careful assessment and prudent implementation of procedures to avoid weakening good banks acquiring bad banks. An assessment of the asset quality of weak banks will be required. Prior to initiating any merger processes, detailed guidelines on mergers and acquisition need to be issued, allowing banks a clear idea about the process involved. Such guidelines can be based on international best practices and provide alternative merger mechanisms for banks to choose from depending on the status of the banks/non-bank financial institutions deciding to merge. Bank mergers will also require an evaluation of internal systems, branch networks, staffing levels,-adequacy of management arrangements, impacts on banks' cross-border business and international risk ratings. Given the high prevalence of NPLs and undercapitalized banks, additional tools will likely be required to address vulnerabilities, including strengthening corporate governance, and introducing stronger financial safety nets such as modern least cost resolution tools for insolvent banks, and stronger deposit insurance. Rapidly implementing bank mergers before addressing these issues may further undermine confidence in the sector, deterring intermediation capacity.

The fiscal deficit will remain moderate, but fiscal space to undertake productive expenditures will increase only gradually. Tepid expenditure growth constrained by subdued revenue mobilization will keep the fiscal deficit below 5 percent in the near term. Reduction in subsidies following the introduction of monthly formula-based adjustment of administered fuel prices and austerity measures to rein in non-essential current expenditures will gradually create fiscal space for productive expenditures. The execution of the Annual Development Plan (ADP) targets will improve gradually due to the government's commitment to reduce delays in the implementation of foreign funded infrastructure megaprojects and a gradual increase in domestic revenues on the back of strengthening growth. Given the tight liquidity conditions prevailing in the market, the risk of increased government borrowing crowding out private investment is considerable. In the short run, muted revenue growth stemming from subdued imports contributes to this risk. In this regard, significantly reduced reliance on the banking system and NSCs to finance the fiscal deficit so far in FY24 are welcome developments. Debt as a share of GDP is expected to remain sustainable with external debt accounting for only 13.7 percent of GDP and only 19 percent of external debt being of short-term maturity.

The current account balance will improve in the short run prior to worsening over the medium term. The current account is expected to remain in surplus over FY24 and FY25 as import restrictions and the difficulties in opening LCs due to foreign exchange shortages persist. It is expected to return to a deficit thereafter as imports rise following exchange rate reforms. Exports are expected to remain moderate as growth in the two largest export destinations—the EU and the US—is projected to be slower than expected. Remittance inflows could increase given the higher outflow of workers in recent years, but only if the gap between the "hundi" (informal) and official exchange rates narrow.

Exchange rate reforms are urgently needed to rebuild the external buffers. Gross foreign exchange reserves have declined sharply over the past year, reaching US$ 20.8 billion in February 2024. Implementing a sustainable exchange rate policy is key to stemming the significant depletion of foreign exchange reserves and restoring market confidence. From January to June 2024, MPS BB indicated it is considering adopting a crawling peg system. The crawling peg would need to be a market-clearing exchange rate mechanism that reduces the gap between the formal and informal exchange rates. This would help rebuild external buffers by attracting remittances through formal channels, making informal channels less attractive, and reducing the financial account deficit by expanding trade credit and other forms of external financing. The reform would also help ensure sufficient foreign exchange liquidity, essential for fulfilling debt service and other external payment commitments.

Significant downside risks to the outlook stem from delayed implementation of external and financial sector reforms. Delays in exchange rate reforms can result in continued depletion of international reserves to critically low levels. Failure to make timely adjustments could result in the persistence of arbitrage opportunities and reduced foreign currency inflows through official channels, thereby perpetuating import restrictions and input shortages. Inadequate supply of natural gas during the peak season and inability to import sufficient LNG due to foreign exchange shortages can disrupt industrial production and investment. Unforeseen natural disasters have the potential to disrupt food production and escalate food inflation, thus keeping inflation higher than projected in the medium term. Additionally, the financial sector may face increased vulnerabilities due to a rise in non-performing loans if the proposed reforms in the banking sector do not improve the capital position of the banks and stem the creation of new bad loans. Fiscal risks include underperformance in revenue collection, realization of contingent liabilities arising from vulnerabilities in the financial sector, and increased monetization of the fiscal deficit.

Structural Reforms

Bangladesh needs significant structural reforms to address the complex set of challenges on its path to achieving Upper-Middle-Income-Country status by 2031. As Bangladesh approaches its graduation from the UN's Least Developed Country (LDC) classification in 2026, it will encounter the challenge of a gradual loss of preferential market access. In anticipation of this transition, Bangladesh needs to adopt policies to boost trade competitiveness and broaden its participation in bilateral and multilateral free trade agreements. Reducing the excessive dependence on RMGs by bolstering the technological and managerial capabilities of domestic firms to enable them to diversify into new areas, promoting integration with Global Value Chains (GVCs), and strengthening the intellectual property rights (IPR) regime and FDI (Foreign Direct Investments) framework can strengthen long-term growth prospects.

Creating an efficient resolution framework for NPLs is urgently needed to maintain financial stability and revive private sector credit. This framework should encompass a comprehensive strategy for addressing the stock and flow of NPLs and a prudent framework for bank resolution. Key components of this strategy include conducting an Asset Quality Review (AQR) of the largest banks, particularly state-owned banks, establishing the necessary legal frameworks for the creation of an NPL market, amending the Bankruptcy Act, implementing supporting regulations, and enforcing rules related to NPL classification, recognition, and provisioning in accordance with International Financial Reporting Standards (IFRS) 9. It is crucial to strengthen corporate governance and enforce regulations such as the Prompt Corrective Action framework (PCA) for weak banks to prevent further deterioration in bank balance sheets. Alongside NPL management, the recapitalization of weak banks will be a vital aspect of the PCA plan. Reforming and enhancing the governance and structure of state-owned banks is essential to ensure financial stability.

Bolstering domestic revenue generation is critical to finance diverse investment needs in the long term. Bangladesh currently collects approximately half of its potential revenue, given its economic structure, level of development, and trade openness. The low revenue collection significantly limits the fiscal space necessary for critical public investments in sectors such as energy, transportation, municipal infrastructure, human capital development, and social sector spending to support vulnerable sections of the population. Rationalizing tax expenditures, adopting a uniform VAT rate, amending the VAT law to facilitate full automation, and reducing supplementary duty and regulatory duty rates to the minimum necessary for transparency and efficiency are critical steps to increase domestic revenue mobilization (see the special section for details on domestic revenue mobilization).

Special Focus: Strengthening Domestic Resource Mobilization

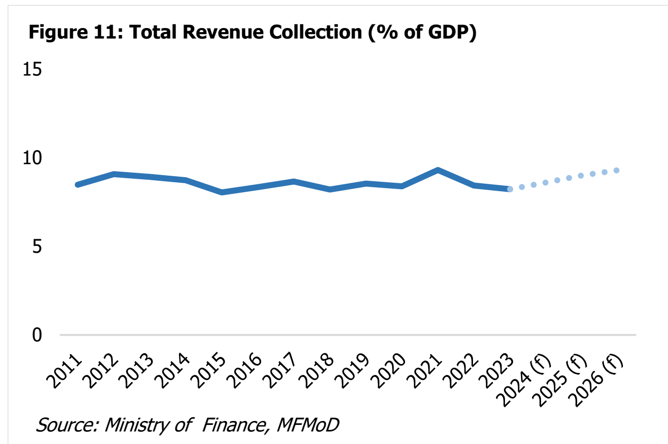
Improving revenue mobilization is critical to increase public resources to support growth and development. Despite rapid economic growth in recent years, Bangladesh struggled to strengthen its domestic resource mobilization. The challenges have been identified in several policy documents, including in the Five-Year Plans and the annual budgets, but revenue generation continued to disappoint. At around 8.5 percent of GDP (FY22), revenue remains insufficient to meet the country's development needs.[4] Given its importance for future economic progress, this chapter analyzes (i) Bangladesh's revenue performance, (ii) the tax structure, (iii) major challenges for revenue generation, and (iv) policy options to address the challenges.

1. Revenue generation

Revenue mobilization failed to keep pace with economic growth in recent years and consistently fell short of budget targets. Bangladesh's revenue as a share of GDP is one of the lowest in the world and significantly below its regional and aspirational peers.

Progress in revenue mobilization stagnated. Revenue collection in Bangladesh remained weak despite strong economic growth in recent years. The revenue-to-GDP ratio declined from 9.1 percent in FY12 to 8.2 percent in FY23. The gaps between actual revenue collection and the targets set in the budget and the Five-Year Plans have increased over time. While 92 percent of the budget target was met in FY13, only 85 percent was met in FY23. The shortfall was even more significant compared to the government's Five-Year Plan. Only 69 percent of the target set for FY23 in the 7th Five-Year Plan was achieved. The 8th Five-Year Plan and the Perspective Plan envision an increase of the ratio to 14.1 percent by FY25 and to 24.1 percent by 2041, respectively (General Economic Division, 2020a and 2020b). These targets are highly ambitious and will require accelerated policy and administrative reforms.

Figure 11: Total Revenue Collection (% of GDP)

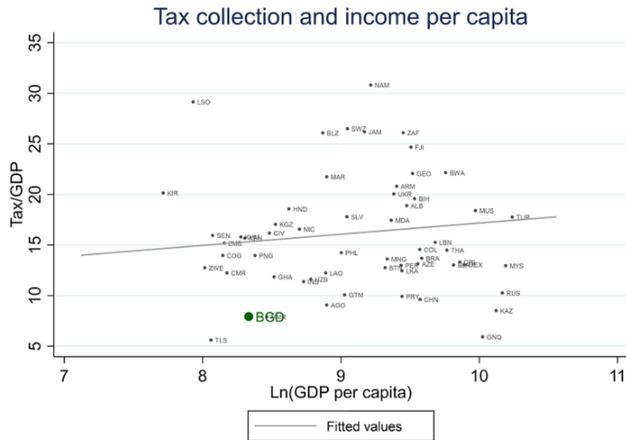


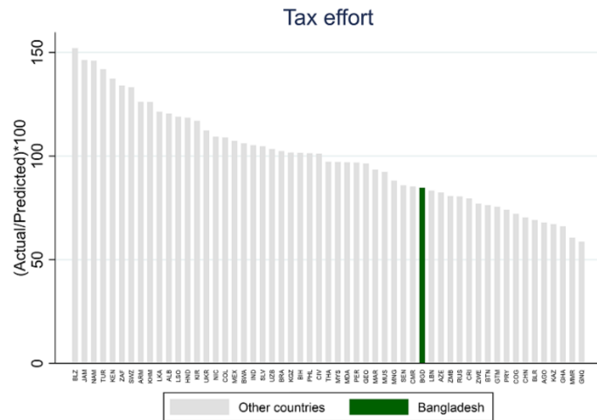
Source: Ministry of Finance, MFMoD

Bangladesh's tax revenue and tax effort are among the lowest in the world. Usually with rising income per capita, the tax-to-GDP ratio tends to increase (Figure 12, left panel). To assess the tax effort, the actual tax revenue generation can be compared to one predicted by a model estimated for a large set of countries. Following the World Bank (2021), such a model is estimated considering different characteristics such as the level of development (approximated by GDP per capita), the share of agriculture, the prevalence of corruption, the openness to trade, and population growth (see Beyer, De Silva, and Khan (2022) for details). Bangladesh's tax revenue generation is lower than the cross-country regression predicts, which confirms Bangladesh's relatively poor tax performance. Among middle-income countries, Bangladesh's tax effort is in the lower third (Figure 12, right panel).

Figure 12: Tax collection and tax effort in Bangladesh and other middle-income countries

[4] Bangladesh Bureau of Statistics (BBS) recently updated the base year for calculating the GDP, increasing the size of the nominal GDP significantly. As a result, revenue as a percentage of GDP in FY22 declined to 8.5 percent from 10.0 percent based on the previous base year.





Sources: WDI, World Bank Governance Indicators, and staff calculations.
Notes: See Beyer, De Silva, and Khan (2022) for details. The left panel shows data for 2019.

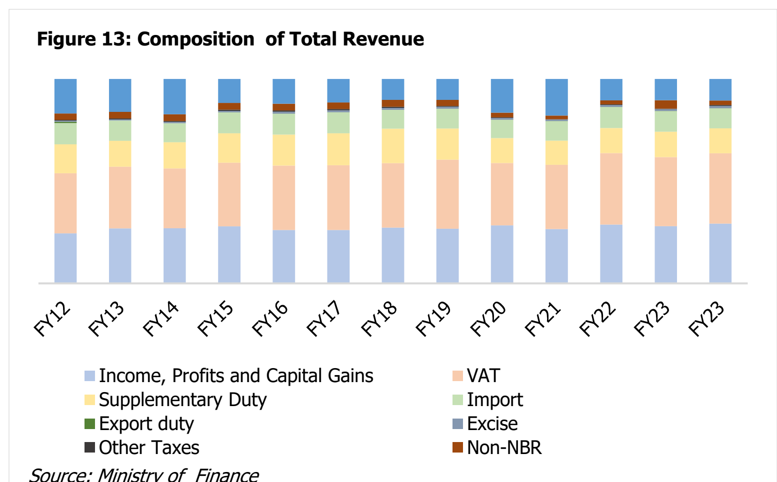
2. Tax structure

Bangladesh's tax revenue is largely dependent on indirect taxes. VAT is one of the major sources of revenue, but a VAT gap analysis shows that there is potential to collect over three times more VAT if there were no policy and compliance gaps. Trade-related taxes, another major source of revenue, are characterized by many para-tariffs. Income tax and corporate tax suffer from very low compliance, with most of the taxes coming from a few large taxpayers.

a) Bangladesh collects relatively low levels of VAT and income tax

Indirect taxes remain the main contributor to tax revenue in Bangladesh. Indirect taxes accounted for around 70 percent of total tax revenue in recent years, with VAT being the most significant contributor (Figure 13). Like in many other developing countries, the tax structure in Bangladesh was largely dominated by trade-based taxation in the first two decades following independence (customs duties alone accounted for about a third of tax revenue).[5] The relative contribution of customs duty declined with the introduction of VAT in 1991, which quickly became the most significant source of revenue. Though most of the VAT is collected domestically, a significant fraction is also collected at the import stage (37 percent of total VAT in FY23).

Figure 13: Composition of Total Revenue



Source: Ministry of Finance

To identify the potential loss in revenue from VAT due to policy decisions and compliance issues, we perform a VAT gap analysis for FY19. The VAT gap analysis is based on the methodology introduced by Hutton (2017) for the IMF Revenue-Administration Gap Analysis program. The VAT gap is defined as the difference between *reference potential VAT* and *actual VAT revenue*, where the former is calculated by multiplying the statutory VAT

[5] To increase the competitiveness of exports and reduce domestic distortions, countries tend to reduce the tariffs as income per capita rises. Doing so requires them to tap into other financing sources, for example by increasing revenue from the VAT.

rate with private consumption.[6] By computing the total VAT potential of the economy under the prevailing VAT policy settings, the methodology further allows the VAT gap to be decomposed into a 'policy gap', driven by VAT exemptions, reduced rates, and registration threshold for firms, and a 'compliance gap', which is the residual. The latter calculation involves the use of input-output tables for information on inter-sectoral linkages and incorporates the typical features of a VAT system such as input tax credits and zero-rating of exports.

The VAT gap for FY19 is estimated at about BDT 2 trillion, which is more than twice the actual VAT revenue, with most of the gap caused by policy choices. In FY19, Bangladesh collected just over BDT 850 billion in VAT revenue, around 4.5 percent of total consumption. However, the reference revenue, which implies full compliance of firms and individuals (zero compliance gap) and no distortions due to exemptions, truncated rates, and registration thresholds (zero policy gap) under a VAT rate of 15 percent[7], is as high as BDT 2.8 trillion. This implies a total VAT gap of about BDT 2 trillion. When policy distortions, including exemptions and incentives, are taken into consideration, the potential VAT becomes BDT 1.5 trillion, indicating a policy gap of BDT 1.3 trillion.[8] Accordingly, the decomposition of the VAT gap into policy gap and compliance gap indicates that just over two-thirds (69 percent) of the gap is due to policy choices that prevailed under the VAT Act in FY19 (see box 3 for a comparison between the previous VAT Act and the current VAT Act that operated from FY20). A sectoral analysis shows that manufacturing and agriculture contribute the most to the policy gap. VAT exemptions and truncated rates usually target the protection of the poor, but in Bangladesh they do not seem to benefit the poor more than the high-income earners (see Beyer, De Silva, and Khan (2022) for details).

Comparing Bangladesh's VAT gap to that in other countries suggests that the compliance gap is relatively large, although data on many comparator countries is unavailable. While VAT gap analyses are not conducted widely in the region (ADB 2018), a comparison of the VAT gap decomposition for countries where results of such analyses are publicly available suggests that both the policy gap (as a share of reference revenue) and the compliance gap (as a share of potential revenue under the existing regime) are relatively high in Bangladesh. Estimated compliance gaps range from 5-10 percent in South Africa to 28-31 percent in Costa Rica, whereas the gap is 42 percent in Bangladesh. In terms of the policy gap, Bangladesh is less of an outlier; policy gaps range from 25-32 percent in South Africa to 64 percent in Sri Lanka, with Bangladesh's policy gap estimated at 49 percent of reference revenue (table 7).

Table 7: International comparison of VAT gap

	Compliance gap (% of potential rev)	Policy gap (% of reference rev)	Period considered
Bangladesh	42	49	2018-19
Costa Rica	28-31	37-40	2012-2016
EU-27	16	41	2009-2012
Pakistan	24		2004-2005
South Africa	5-10	25-32	2007-2012
Sri Lanka	23	64	2017

Sources: World Bank (2019), Asian Development Bank (2018), Ahmed and Rider (2008), Center for Social and Economic Research (2014), International Monetary Fund (2015), International Monetary Fund (2018)

NBR has struggled to increase the share of direct taxes in total revenue. Contribution of taxes on income, profits, and capital gains in total revenues is low and fluctuated within a narrow band of 25 to 28 percent in the last several

[6] Since the VAT is effectively a tax on consumption, private final consumption here works as a proxy for the tax base.

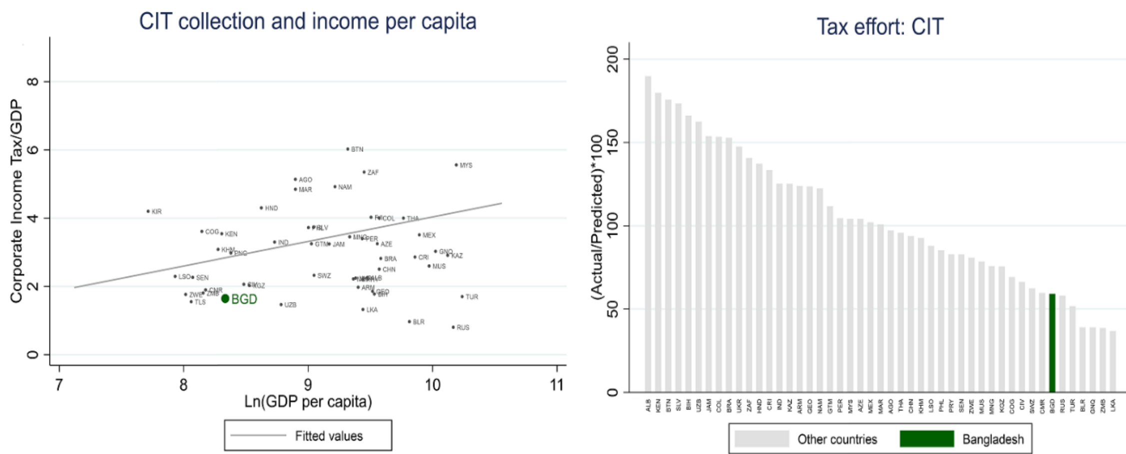
[7] The 15 percent VAT rate is based on the VAT and Supplementary Duty Act 1991 that was in effect in FY19.

[8] Policy gap is the difference between the reference VAT and potential VAT with existing policies.

years. Tax compliance has been extremely low, with only about 3 to 3.5 million people paying income taxes out of about 10 million tax identification number (TIN) holders.[9] About one-third of the income tax revenue comes from the Large Taxpayers Unit (LTU), consisting of major mobile phone operators, tobacco companies, private banks, and high earning individuals.

The amount collected from direct taxes is much lower in Bangladesh than in comparable countries. Among middle-income countries, the revenue from personal income taxes relative to GDP does not increase with rising income levels, but the revenue from corporate income taxes (CIT) does increase (Figure 14). Bangladesh performs much worse than other countries for both personal and income taxes, especially when the comparison includes other characteristics. Bangladesh only generates two-thirds of the predicted amount in personal income tax and less than 60 percent of the predicted amount in corporate taxes. For the latter, Bangladesh is among the worst performing middle-income countries.

Figure 14: Corporate income tax collection in Bangladesh and other middle-income countries



Sources: WDI, World Bank Governance Indicators, and staff calculations.
Notes: See Beyer, Khan, and De Silva (2022) for details. The left panel shows data for 2019. The figures on the CIT do not show Kiribati and Moldova, which generate very high CIT revenue.

b) Customs duty collection is high, but the government has committed to reducing tariff and non-tariff barriers

Nearly one-third of total tax revenue originated from trade-related taxes in the last decade. Trade taxes in Bangladesh include taxes from customs duty, VAT, and supplementary duty at the import stage.[10] Customs duty used to be the highest contributor to trade-related taxes in the past, but VAT at the import stage overtook customs duty from FY10. Revenue growth from para-tariffs such as the supplementary duty has also been high (see box 2 for more analysis on the tariff structure).

Revenue collection from the customs duty is higher than in other comparable countries. Customs duty collection usually declines with higher income. Relative to income per capita, Bangladesh generates roughly the expected amount from customs. However, a more meaningful comparison of the generation of revenue from customs needs to consider characteristics beyond just the level of per capita income. When additional characteristics are reflected, Bangladesh collects 1.8 times more than predicted based on the collection in other middle-income

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[9] Tax return submission rose recently as a result of new provision that requires proof of submission of tax return to receive 38 public services.

[10] NBR also earns some revenue through export duty, but its share in overall collection is insignificant.

countries (Beyer, De Silva, and Khan 2022). Hence, Bangladesh's customs collection far exceeds what would be expected based on explanatory variables (i.e., the prediction of the model).

Box 2: Tariff Structure in Bangladesh

Bangladesh has made significant progress in tariff modernization in the last three decades. It simplified the tariff structure by moving from 22 customs duty rates in FY92 to only six non-zero rates by FY17. Over 95 percent of tariff lines are ad valorem and therefore transparent.

However, additional taxes on imports reduce the transparency of the tariff regime and increase the complexity of trade policy. These include 10 specific duties, regulatory duties, and several Advance Income Taxes. Bangladesh's average tariff spikes from 14.8 percent to 25.0 percent if all import taxes such as regulatory or supplementary duties are considered, which is significantly higher than countries with similar income levels. In FY20, the average nominal protection rate on imports was equivalent to 29.6 percent at rates ranging from zero percent to 668 percent (for vehicles of cylinder capacity over 4000 cc). This high degree of nominal protection – both average and variation across different HS Codes – has created an enclave for domestic industries, incentivizing them to focus on the domestic market rather than exports, due to relatively higher profitability, known as anti-export bias (Kathuria and Rizwan 2020, CEM 2022).

Bangladesh has much higher tariffs than East Asian competitors. Most Favored Nation (MFN) tariff on intermediate goods would need to be cut by half (from 12.4 percent to 6.2 percent) and all other import taxes eliminated (from 6.4 percent to zero percent) for Bangladesh to reach similar levels of taxation on intermediate goods as those prevalent in East Asian comparators. Additionally, with an almost 30 percentage point difference in tariffs (including other import taxes) for consumer and intermediate goods, Bangladesh shows the highest tariff escalation among comparators by a wide margin.

The tariff regime in Bangladesh should adhere to principles such as transparency, simplicity, and efficiency. This could be achieved by moving towards low and uniform tariffs, adopting a single rate for similar goods, irrespective of origin, and removing the anti-export bias to foster a globally competitive export industry. In the medium to long term, policies should be geared toward stimulating exports from sectors other than RMG. Bangladesh needs to reduce para-tariffs gradually, with the goal of eventually eliminating them and making the tariff structure consistent with that of an upper middle-income country as it prepares to graduate from LDC status and face the consequent change in Special and Differential Treatment under World Trade Organization (WTO).

c) Non-tax revenues are low

Figure 15: Non-tax revenue over time

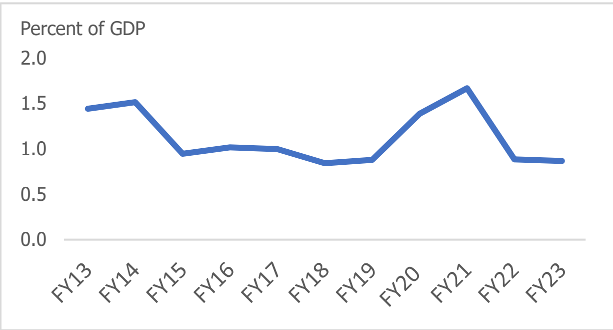
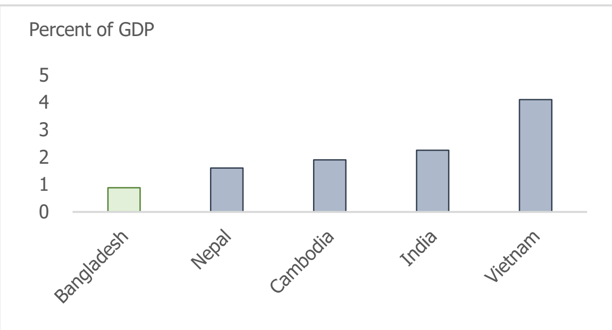


Figure 16: Non-tax revenue relative to others (2023)



Source: Ministry of Finance, MFMoD.

Non-tax revenues as a share of GDP are lower than in comparable countries. Non-tax revenue as a percentage of GDP declined from 1.5 percent in FY14 to 0.9 percent in FY19 (Figure 15). However, it picked up again in FY20 and FY21 driven by a new law that allowed the government to transfer idle funds from state-owned enterprises to the government exchequer. Despite this rise, non-tax revenues again fell to 0.9 percent of GDP in FY23 and

remains lower than in most peer countries (Figure 16). Major sources of non-tax revenues in Bangladesh include dividends, profits, interest, tolls and levies, different administrative and service fees. Provisional data from MoF indicate that the non-tax revenue growth was robust in the first quarter of FY24.

3. Major bottlenecks

There is significant room to pursue tax policy reforms to raise the very low domestic revenue mobilization. Automation of the VAT and income tax systems has been initiated, but the implementation remains a work in progress. Within a fragmented tax administration, the manual and paper-based tax collection provide tax officials enormous discretion. Moreover, the government is deprived of large amounts of tax revenue every year due to money laundering, tax evasion, and illicit capital flows. Most of these challenges have persisted for at least the last decade despite being recognized by the government but are not yet resolved.

a) Tax policy

A new VAT law was implemented in FY20, but with a significant delay and reversal of changes from the originally proposed version in 2012. The VAT Act of 1991, which introduced the VAT system in Bangladesh, was replaced by the VAT and Supplementary Duty Act 2012. Although Parliament passed the Act in 2012, implementation was delayed due to resistance from key stakeholders, including the business community. The new VAT act was finally implemented in June 2019, but with major amendments to the original version (see box 3).

Box 3: The VAT and Supplementary Duty Act 2012

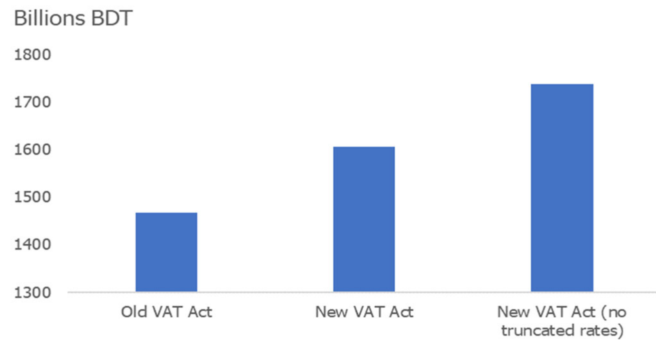
Reforming the VAT system has been challenging. The VAT Act of 1991 started to lose its efficiency as the economy grew and became more diverse. As a result, the VAT and Supplementary Duty Act 2012 was enacted by the Parliament in 2012 to replace the 1991 Act. However, the new Act's main feature - a 15 percent standard rate with input credit for firms along the value chain – faced resistance from different stakeholders, including the business community. After extensive discussions and debates, the new law finally came into effect in July 2019 but with major amendments. The new Act is much more complex than its original version and is similar to the 1991 version. Instead of the originally proposed single rate of 15 percent, the new Act included multiple rates (5 percent, 7.5 percent, 10 percent, and 15 percent) and two special rates on pharmaceuticals (2.4 percent) and petroleum products (2.0 percent). The 2019 VAT law included a new provision (under Section 72.5), which requires all registered firms to submit input-output coefficients in a specified manner to their respective VAT offices. This creates further complexities.

The new Act also differs from the original version in its application of the supplementary duty. The original version aimed at lowering the protection on domestic production by reducing the number of products subject to supplementary duty and by applying it equally to domestic and imported goods. By applying it primarily on imports, the new VAT Act does not help reduce protection.

Full implementation of the new Act and related measures remains a work-in-progress. The new VAT Act was supposed to be complemented by reforms in the tax administration and automation of the VAT system. The implementation of the law was initially delayed for three years to first establish the following: an automated VAT system with minimum manual operation required; a transition from a geographic structure to a function-based organizational VAT structure; and an installation of Electronic Fiscal Devises (EFD) in all major retail outlets. None of this has fully materialized as of today, raising concerns over the effectiveness of the new VAT law.

However, a simulation of the effect of enacting the new VAT Act 2012 still shows an increase in potential VAT revenue. To compare the new VAT Act to the old one, both need to be applied to the same fiscal year. Hence, a counterfactual is simulated to understand whether the new VAT Act implemented from FY20 would have made any difference if implemented in FY19. The counterfactual estimates the potential VAT in FY19 with the exemptions and truncated rates set out in the new VAT Act.[11] Imposing the new set of VAT exemptions and truncated rates shows that revenue potential would have been 9.5 percent higher, which is equivalent to BDT 139.4 billion.[12] However, a simulation based on a VAT Act with no truncated rates, as envisioned in the original version of the Act, shows that potential revenue in FY19 would have increased further by 8.1 percent and 18.4 percent compared to the new VAT Act (with truncated rates) and old VAT Act, respectively (Figure 17).

Figure 17: Potential VAT in FY19 for different VAT policies



Source: MoF and World Bank Staff calculations

The relative tax burden of the new Act continues to be very similar for different income groups. We also simulate the incidence of the VAT system after the enactment of the new VAT Act 2012, to study the distributional impact of the change. The total VAT incidence on the poor increased only slightly, driven by increases in the direct VAT burden due to the removal of exemptions to final consumption goods. At the same time, the removal of preferential rates at the intermediate stages of production results in a reduction of the indirect burden of VAT.

Corporate tax compliance is poor. According to NBR data, more than 56 percent of firms do not have a TIN, and over 55 percent of the TIN-holding companies do not pay corporate taxes. Only a handful of telecom operators, tobacco companies, and banks account for the bulk of the collection. In the FY22 budget, the corporate tax rates for non-listed companies and listed companies have been reduced by 2.5 percentage points to 30.0 percent and 22.5 percent, respectively. Yet, the rates are still higher than in many competitor countries and aspirational peers in South-East Asia.[13]

Lower tax rates may or may not prevent tax evasion. In many developing countries, businesses avoid taxes when they find compliance can distort their production decision. A low tax rate causes minimal distortion to production decisions, and therefore may encourage businesses to comply. However, to what extent lowering tax rates will be successful in curbing evasion in Bangladesh needs rigorous data-based assessment.

Political economy dynamics have been a major barrier for meaningful reform. While the need for reform has been acknowledged by different experts and stakeholders, it has proven challenging to reach a consensus on concrete policy changes. These issues occurred despite a relatively stable political environment in the last decade. The current tax administration system delivers low and predictable tax rates to businesses, but it also allows for significant administrative discretion, which may lead to inconsistent application of tax laws and opportunities for corruption. Implementation of stronger control processes and greater automation would help prevent potential abuse. The research from Bangladesh and other international experiences supports the hypothesis that tax reforms are essentially political in nature and cannot succeed without reform champions at the highest level (Ahmed, 2020).

[11] Alternatively, one could have applied to old VAT Act to FY20. However, revenue collection in FY20 was significantly affected by COVID-19 and is hence less suitable for such an analysis.

[12] Note that this simulation assumes that price changes are completely passed through to consumers, who do not change their purchasing behavior in response to these price changes (in other words, final consumption remains unchanged by change in VAT).

[13] For example, the corporate tax rate in Cambodia, Vietnam, and Thailand is 20 percent.

b) Tax administration

The manual tax system remains a major bottleneck. Many regular operations are still conducted manually. The planned automation of tax and VAT collection has not been successful on a large scale and most of the records are still paper based, causing significant inefficiency. Papers are often dumped in a disorderly manner, making it extremely difficult to extract needed information at a later date. The manual system further makes it difficult to share data among the three wings of the NBR. With the current practice of manual operation and record keeping, tax administration will be exceedingly difficult, especially if the number of taxpayers increases to 10 million as per the NBR target.

The problems are aggravated due to a high degree of administrative fragmentation. Although most of Bangladesh's peer countries moved towards greater integration of tax administration, Bangladesh mostly maintained an administrative structure inherited from the British colonial system that maintained separate direct tax, VAT, and customs wings. NBR collects taxes through main administrative units called Commissionerates at the district level, which are led by senior field level tax officials known as Commissioners. The staff in these three wings come from two different cadre services: i) customs and VAT, and ii) direct tax. Efforts to merge the two cadre services have failed in the past due to staff resistance. The lack of integration and data sharing among the three wings and two different cadre services lead to inefficiency.

A significant trust deficit is a major barrier. A lack of trust in the tax collection authorities discourages many individuals and firms from paying proper taxes. Declaring the actual assets in the tax return form can result in tax-related harassment. The fear of tax-related harassment can be so significant that small firms can prefer to stay informal and forgo many benefits of government support programs, including access to formal credit (Ahmed,2020). Honest taxpayers get frustrated when they get subjected to additional investigation, while evaders are not brought under scrutiny. Moreover, taxpayers get demoralized with recurring opportunities to legalize the 'undisclosed money'. The NBR and the Anti-Corruption Commission are not allowed to raise any questions on such declarations. Such policies create a moral hazard problem and widen the trust deficit.

c) Automation

Automation of the VAT system faces several challenges. NBR has developed 16 modules of the Integrated VAT Administration System (IVAS), of which 13 have become operational. The NBR is yet to make policy decisions on 3 partially completed modules which are not yet 'live' (audit, risk management, and objection and litigation). Sixty percent of large taxpayers are now submitting online returns and using e-payments through 11 commercial banks, and the coverage will increase when more banks are connected to the national payment gateway. The average time to process and issue tax refunds was reduced from the baseline of 120 to 90 days. Going forward, compliance measures can be enforced through implementation of the audit, risk management, and litigation modules and integration with the tax and customs systems. Furthermore, integrating the IVAS with key service providers in public and private sectors to promote data exchange and authentication enhanced transparency in VAT administration.

There are plans to install Electronic Fiscal Devices (EFDs) in all major retail outlets.[14] After previous attempts to enforce the use of electronic cash registers failed due to the absence of electronic servers to monitor transactions, NBR decided to set up the EFDs and sales data controllers (SDCs) in 2017.[15] The EFDs are expected to capture transactions in real time and to help detect VAT avoidance. The use of the EFDs started on a pilot basis only from

[14] An Electronic Fiscal Device (EFD) is used by businesses to control tax-related transactions.

[15] SDC is used for preventing tax evasion on cash registers, point of sale systems, and other invoicing systems.

August 2020 and are mandatory for 24 types of shops and service providers.[16] Implementation has lagged targets. To date, 9,270 EFD/SDC machines have been installed. The current plan is to install 60,000 EFD/ SDCs in the first phase of implementation. If implementation is successful, 300,000 machines will be installed over a five-year period (Medium Term Macroeconomic Policy Statement, MoF, 2023).

The NBR has made attempts to automate the income tax return submission but has faced implementation challenges. The Bangladesh Integrated Tax Administration System (BITAX) aimed at expanding the current low personal income tax base by simplifying the return submission procedure. However, the lack of coordination between the authorities and the contractor resulted in only partial implementation of the project. The authorities introduced the e-filing facility in 2016, but it failed to attract taxpayers to submit online returns due to several technical issues at the beginning. A mere 0.3 percent of the total 2.2 million tax returns were submitted online in FY20, which included no large income taxpayers. However, due to some simplification of the process, more than 10 percent of the tax returns were submitted online in the recently completed tax year of 2023-24.

d) High tax expenditure, illicit capital flows, and informality

Tax expenditures are high. There are many forms of exemptions, deductions, rebates, tax holidays, and referral credits that deprive the government of a significant amount of revenue each year. Some of these are announced during the budget every year, while others are announced at different times of the year through Statutory Regulatory Orders (SROs).[17] One of the goals of such incentives is to attract private investments. For example, businesses operating in Special Economic Zones (SEZ), High Tech Park Zones, and Export Processing Zones receive lucrative tax breaks, including 100 percent exemptions for the first few years. The largest export earning sector for Bangladesh, the RMG sector, enjoys a reduced tax rate of only 12 percent, lower than most publicly listed companies (20 percent) and non-listed companies (27.5 percent). Large benefits were also given to the power sector to attract more private sector investment. Many emerging sectors are also benefiting from tax and VAT incentives. In addition, there are several tax exemptions for incomes earned through agriculture, foreign employment, dividends, gratuities, certain types of bonds, corporate social activities, and donations. According to a recent study by the NBR, tax expenditures were 3.5 percent of GDP in FY21 for direct taxes. Many of these tax exemptions are offered on an ad-hoc basis rather than following any strategic approach.

Illicit capital flows through various means have been depriving the government of revenues. Illicit capital flows to offshore accounts have been on the rise. According to the State of the Tax Justice Report 2020, offshore financial wealth of Bangladeshi's is estimated at 0.7 percent of GDP. The tax revenue losses, which include losses from corporate abuse and offshore tax evasion, are estimated at over US$ 700 million or 2.2 percent of FY20 revenue. This is high compared to some of Bangladesh's peer countries. Bangladesh currently ranks 54 among 133 countries in the Financial Secrecy Index, which measures how intensely country's tax and financial systems serve as a tool for individuals to hide their finances from the rule of law.[18] Most of the money laundering in Bangladesh occurs through trade mis-invoicing. According to the latest Global Financial Integrity Report 2021, as much as US$ 3.6 billion per year has been laundered from Bangladesh through trade mis-invoicing on average between 2009 and 2018. Bangladesh ranked 44th globally and 3rd in South Asia in terms of illicit outflows of money through trade mis-invoicing.

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[16] This includes hotels, restaurants, jewelry and furniture shops, beauty parlors, departmental stores, general stores or super shops, cinemas, among others.

[17] SRO is a legal directive that outlines specific tax, customs, or excise regulations. They are typically used to implement new tax rules, amend existing ones, or provide clarifications on tax-related matters. An analysis of income tax wing has found some 34 statutory regulatory orders were issued during FY19.

[18] The higher the ranking, the more a country's laws and policies facilitate hiding of private finances.

Bangladesh has a large informal economy that remains outside the tax net. Despite strong economic growth and a structural shift from agriculture to manufacturing and services over the last two decades, the share of informal economic activity remains high. Based on the Labor Force Surveys by the Bangladesh Burau of Statistics (BBS), the share of employment in the informal economy has increased from 75 percent in FY00 to 84.9 percent in FY22 Even in more formal manufacturing sectors like the RMG and leather industry, back-end production continues to be dominated by informal enterprises. Although such enterprises have TIN/VAT registration (stipulated by law), they overwhelmingly remain outside the purview of fiscal authorities (Rahman, Bhattachariya and Al-Hasan, 2018). Many firms in the informal sector prefer to stay informal to avoid paying taxes and to be able to ignore statutory obligations of paying pensions or gratuities to their workers. Many informal businesses perceive the costs of formalizing and complying with tax policies to outweigh the benefits of formalization, such as greater access to finance through formal banking channels (International Finance Corporation (2013)). Feedback from firms and the Tax Perception and Compliance Cost surveys indicate that more firms would consider formalization if the tax regime were simplified.

4. Policy recommendations

a) Adopting modern tax policies and automation

Reverting to the original 2012 VAT law would be more effective in raising taxes. The new VAT and Supplementary Duty Act that went into effect from June 2019 would have been more effective in raising revenue if implemented without any changes from the original 2012 version. As envisioned in the 8th Five-Year Plan, the current version of the law could be more aligned with the 2012 version by reintroducing a single VAT rate, removing additional complexities, and truncated VAT rates to make the law more efficient.

A major priority is to increase the number of taxpayers. Traditional methods of improving tax compliance have generally relied on audits coupled with penalties for non-compliant firms. These are costly and subject to opportunities for corruption. A complementary strategy is to rely on reward-based methods. Easing registration procedures and reducing registration fees or providing financial incentives conditional on registration and filing as well as social recognition are inducements that could raise tax compliance.

Achieving efficient and broad-based automation will be crucial. An automated system that is easy to use for taxpayers and able to fill the loopholes in the system is a crucial step toward preventing tax avoidance and corruption. The automated system should be able to identify individuals and businesses who are: i) registered in the system but are not submitting returns and ii) who are registered, submitting returns, but are not paying their due share of taxes. In terms of income tax, activities such as filing of returns, processing of returns, assessment of total income, computation of taxes, and payment of taxes, need to be automated and linked to the taxpayers' national identity numbers (NID). Ideally, tax authorities should be able to fetch and verify the information of each taxpayer with minimum effort. Similarly, for the VAT, all modules need to be activated as early as possible. Ensuring proper and broad-based use of the EFD will expedite VAT collections. The three wings of NBR could share data and information through a common database.

b) Reducing reliance on indirect taxes by improving direct tax collection

A higher share of revenue could be generated through direct taxation. For the income tax, the best approach would be to promote voluntary compliance. As the incomes of households increase, opportunities to earn more tax revenue through additional wealth tax and capital gains tax could be explored. Property taxes are currently collected by the local governments based on rates that have not risen with property prices. The tax rates could be updated and combined with the wealth tax collected by the NBR to make the system more efficient. A modern

property taxation system could be established with rates based on the true market value of the property. Going forward, Bangladesh plans to pursue more free trade agreements (FTAs) and preferential trading agreements (PTAs) to address the loss of preferential market access when it graduates from LDC status. Income tax and VAT revenues will need to rise to compensate for the resulting decline in trade tax revenues.

Rationalizing the existing tariff policy by reducing tariffs and para-tariffs and addressing the anti-export bias would support competitiveness. Average tariffs on intermediate in Bangladesh (18.8 percent) are higher than comparator countries, such as China (7.4 percent) or Thailand and Vietnam (9.6 percent). A proliferation of para-tariffs like the supplementary duty and the regulatory duty, has also promoted protectionism and created an anti-export bias, particularly for non-RMG products. Rapidly growing economies have tended to reduce tariff barriers to promote trade and sustain growth over the long run. Tariff rationalization could include moving toward low and uniform tariffs and adopting a single rate for similar goods, irrespective of origin. Para-tariffs could also be reduced in phases with a time-bound and performance-based approach. Reducing the para-tariffs could lower the revenue collection in the short term, but it will promote export diversification and economic growth which in turn will raise revenue collection in the medium to long term. The adoption of the National Tariff Policy (2023), the country's first-ever tariff policy, provides guidance on tariffs, para-tariffs, access to bonded warehouses, and other related issues. Implementing the policy through subsequent national budgets is urgently required so Bangladesh can prepare for negotiation of trade agreements following LDC graduation.

c) Reducing tax expenditure and addressing political economy constraints

It is critical to reduce tax expenditures. The underlying rationale for providing different tax benefits, such as creating growth opportunities for promising sectors and attracting local and foreign investments, needs to be revisited regularly to remove tax benefits that are not delivering the intended benefits. The decision to provide tax incentives will need to be based on a rigorous comparison of expected benefits and the revenues forgone. The number of SROs provided after the budget and offers of tax exemptions given on an ad-hoc basis need to be reduced to maintain policy consistency. Due to the lack of proper quantification of revenue loss due to such incentives, it has been difficult to take concrete actions. However, in a recent study, the NBR estimated the total tax expenditure for direct taxes in FY21 to be 3.6 percent of GDP.

Political economy constraints in improving domestic resource mobilization should be identified and addressed. Political economy constraints played an important role in the cancellations, reversals, and delayed implementation of reforms related to domestic resource mobilization, including the delayed preparation and implementation of the new Act on VAT, income tax, customs, related automation, and reforms in tax administration. The implementation of broad policy and administrative reforms will require extensive stakeholder consultation and clear communication plans to manage pressure from vested interests, while strengthening confidence in the effective management and spending of public resources mobilized. Political economy analysis can help shape an effective reform strategy, informed by the successes and challenges of previous reform attempts.

Gaining the trust of honest taxpayers and those who are willing to pay their fair share could support revenue mobilization. For many years, the GoB provided the opportunity to taxpayers with undisclosed assets to legalize their wealth by paying a low tax rate and investing in certain sectors, such as the stock market and real estate. While a one-off decision to earn revenues through such measures can be beneficial in bringing some undisclosed assets under the system, continuation of such policies demotivates honest and regular taxpayers and encourages tax evaders to continue their misdeeds by creating an expectation that they will be able to legalize their wealth. Also, these policies have failed to earn a significant amount of revenue.

d) Building a modern and integrated tax administration

Greater integration and data sharing among the different wings of the NBR is critical for a more modern tax administration. An effective tax administration minimizes the costs of operation, ensures compliance of taxpayers, and reduces discretion and discrimination by increasing transparency. To this end, a greater integration of the three wings of the NBR in terms of data sharing is essential. Connecting the Business Identification Number (BIN, maintained by the VAT and Customs Wing) and Tax Identification Number (TIN, maintained by the Income Tax Wing) could be useful in terms of reducing loopholes. Furthermore, to detect rampant tax evasion through money laundering and transfer pricing, the Central Intelligence Unit (CIU) and other intelligence units of the NBR need to work together with relevant units of BB, such as the Bangladesh Financial Intelligence Unit, and the Anti-Corruption Commission.

Tax policy may be separated from tax administration. The current structure provides NBR the authority to formulate tax policy and carry out tax administration. Furthermore, there are separate policy departments under each of the three wings of the NBR, a structure that is not conducive to coordinated policy formulation. Having the authority to both set tax policies and collect taxes can create a conflict of interest and make realistic revenue targeting difficult. Previous attempts to create a separate unit for tax policy within MoF were not implemented. Separating tax policy and administration would allow for a more comprehensive reform program, with integrated planning for tariffs, taxes, and non-tax revenue.

Capacity building of NBR officials is needed to ensure robust technical analysis and effective policy formulation. Over the years, NBR has received technical support from development partners, which helped increase the technical capabilities of NBR officials. However, as Bangladesh aspires to climb up the income ladder, it will be important to have a revenue administration able to produce analysis and policy of the highest quality. NBR needs the capacity to analyze the impact of taxation on economic activity, produce reliable revenue forecasts, and conduct top-notch tax expenditure analysis. Hiring temporary external tax professionals with proper incentives could help fill the knowledge gap in the short to medium term.

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