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TAX REVENUE AND THE EFFECTIVENESS OF FISCAL POLICY: BANGLADESH PERSPECTIVE

Sara Tasneem[1]

Abstract *Fiscal policy is of great importance in a developing country like Bangladesh. Tax revenue is not only a tool to implement the fiscal objectives but also a factor to determine fiscal policy effectiveness. The main aim of the study is to portray the contribution of tax revenue to economic growth, macroeconomic stability etc which are intended to be achieved by fiscal policy. Following a time series data from fiscal year 1989-90 to FY 2010-11. The prime finding of the study reveals that the tax revenue strives to attain the fiscal goals. The study also portrays the stimulating role of tax revenue to government to accomplish macroeconomic activities.*

Keywords: *Tax revenue, Fiscal policy effectiveness, Time SeriesData*

Introduction

Fiscal policy can be termed as a tool for 'fine-tuning' of the economy. Fiscal policy in Bangladesh fundamentally encompasses activities, which the country carries out to gain and utilize resources to provide services to ensure maximum efficiency of the economy. Ensuring macroeconomic stability, GDP growth and equitable distribution of income are the major fiscal objectives. Public revenue is the prime instrument to achieve the fiscal target. Tax revenue is of great and crucial importance. This domestic resource is one of the mechanisms to get rid of foreign financial assistance dependency. Availability of foreign loan and grant may gradually become uncertain and volatile for a country. On the other hand, domestic borrowing by government sometimes results in crowing-out effect. And the scope of non-inflationary financing is limited. In such a circumstance, tax revenue can be considered and applied to achieve the fiscal objectives. It always lends the hand for proper implementation of revenue budget. Using tax revenue reinforces government to be more accountable and efficient in general administration. In current global economic crisis, more reliance on tax revenue will enhance the strength of the economy. The paper will focus on the benefits of using tax revenue to meet the fiscal objectives and to ascertain the role of tax revenue as a tool to make fiscal policy effective.

Literature Review

Claus et al. (2012) assesses the impact of government fiscal policies on income inequality in Asia. It discusses the role and effectiveness of redistributive fiscal policies and quantifies the effects of taxation and government expenditure on income distribution. Panel estimation for 150 countries with data between 1970 and 2009 confirms

1. Lecturer, Faculty of Business and Economics, Daffodil International University

international empirical findings for Asia. Tax system tends to be progressive but government expenditures are a more effective tool for redistributing income. Moreover, the results suggest some distinctive differential distributive effect for government expenditure on social protection in Asia. Social protection spending appears to increase income inequality in Asia, whereas it reduces in the rest of the world.

Auerback (2005), in a study regarding the effectiveness of fiscal policy as stabilization policy in case of US economy from 1960 to 1970, found that the direct effects of fiscal policy on consumption, investment and government spending as well as the overall effects on output, suggest that the fiscal policy can have a large, rapid impact on economic activity. Increasing budget pressure may weaken the effectiveness of tax cuts and other fiscal policies that depend on expectations of policy durability. Fiscal policy has the potential to be used for economic stabilization.

Islam and Biswas (2005) analyze that the issue of public debt and debt sustainability has long been a concern for policy makers of both fiscal and monetary authority in Bangladesh. High public debt stems from persistent fiscal deficit and has a significant negative effect on economic activity. It is important for overall macroeconomic policy to manage debt. The main objective of fiscal policy in Bangladesh is to enhance the effectiveness of public expenditure by channeling resources to the appropriate direction and attain faster growth and poverty reduction by mobilizing larger amount of revenue. With a view to fostering economic growth and accelerating poverty reduction, Bangladesh has been pursuing expansionary fiscal policy since its independence. As a result, total expenditure very often exceeds total revenue which generates fiscal deficit. Economic theory tells that if debt management is met by borrowing from central bank, it is inflationary; if borrowing is from commercial banks, there is a possibility of crowding out of private sector investment. Again, if it is met by issuing bonds, the cost debt financing will high (Dornbush and Fisher, 1990).

Kuttner and Posen (2002) investigated the effectiveness of Japanese fiscal policy over the 1976-1999 period using a structural VAR analysis of real GDP, tax revenues and public expenditures. They found that expansionary fiscal policy whether in the form of tax cuts or of public works spending, had significant simulative effects. Using a new method of computing policy multipliers from structural VARs, they calculated that the multipliers on tax cuts is about 25% higher at a four-year horizon than on that public works spending, through both are well in excess of one. A historical decomposition reveals the Japanese fiscal policy was contractionary over much of the 1990s, and a significant proportion of the variation in growth can be attributed to fiscal policy shocks; accordingly, most of the run-up in public debt is attributable to declining tax revenues due to the recession.

Ducans et al. (2006) in a study of four Asian countries – Bangladesh, China, Indonesia and the Philippines by means of structural macroeconomic simulation found that short-term fiscal multipliers from an untargeted increase in government expenditure are positive but much less than those from an increased expenditure targeted to capital spending. The multiplier effects from fiscal expansion via a tax rate reduction are found to be typically much less than through higher spending.

Swift Li Zhicheng in a study of tax expenditure, demonstrate that tax expenditures affect the budget balance, budget prioritization in allocation, the effectiveness and efficiency of fiscal resources and the scope for abuse by taxpayers, government officials and legislators. The study sketched building blocks to strengthen tax expenditure towards fiscal accountability and transparency. The paper argues that normative tax structure, a revenue-raising component of the tax system should be formalized. When the tax revenue-raising activity is formalized, the inherent spending nature of tax expenditure is further exposed. Therefore, tax expenditures, forming total government expenditures.

Haider et. al. (1988) found that government of underdeveloped economies such as Bangladesh play a key role in the development efforts either by directly carrying out a large part of the investment programs of the country and/or indirectly supporting private sector by taking up necessary expenditure for large infrastructure development program. Hence, the shares of public sector in these economies have grown considerably in recent past. This huge public expenditure is financed by taxes, non-tax receipts such as profits of public enterprises, domestic and international borrowings etc. Taxation is again the most important policy instrument in the armory of the government to carry out its objectives of raising revenue to meet the increasing public expenditure keeping such other broader objectives of the government as equity, efficiency, self-reliance etc. in mind.

The studies discussed above have focused on different issues of fiscal policy such as the impacts of the policy on different macroeconomic variables, stimulating economic activities, contractionary vs. expansionary policies, debt management issue, stabilizing role of the policy etc. But the factors determining the effectiveness of the fiscal policies are explained in the literature in a multidimensional way. There are many factors controlling the effectiveness The factors may be the financing mix of government expenditure, the posture of monetary policy, status of the macro economy, nature of the fiscal policy(expansionary or contractionary) and tax revenue. Accommodative monetary policy results in effective fiscal policy. Actually monetary and fiscal policies ought to be complementary. But the role of tax revenue on fiscal policy effectiveness remains undocumented. The prime limitation of the above discussed studies is to ignore the role of tax revenue as a factor on effectiveness. The present study has tried to highlight the issue. The present study is different from the existing studies because a) it has treated tax revenue as a factor determining effectiveness rather than an instrument of fiscal policy b) it has analyzed the impacts of tax revenue on some relevant variables of fiscal management in such a technique which will make the role tax revenue to fiscal policy effectiveness clear. It is anticipated that the findings of the present study will help the policy makers to think how to use tax revenue in a more efficient manner and illustrate the benefits of tax revenue to citizens.

Objectives

The general objective of the study is to analyze the positive impacts of tax revenue on fiscal policy effectiveness. The study focuses on some multidimensional variables on which tax revenue is creating impacts and via these impacts the revenue is positively related to economic development which is targeted to achieve by policy options. The specific objectives are (i) to examine the impacts of tax revenue to foster economic growth; (ii) to give a picture of how tax revenue is trying to minimize the debt burden of the government (Debt management and reducing dependency on foreign aid); and (iii) to evaluate how tax revenue is trying to achieve macroeconomic stability (in terms of reducing unemployment and creating new employment opportunities).

Methodology

At the outset of the discussion of methodology adopted in the study, the term "effectiveness" should be made clear in sense. Conventionally, effectiveness indicates productivity or output to input ratio. Dissimilar to this concept, the present study indicates, the fiscal policy is effective if it is designed in such a manner so that the policy incentives (may be considered as input) can reach the objectives (may be considered as output). In scrutinizing the fiscal policy effectiveness, it is of significance to study the fulfillment of fiscal objectives by tax revenue. The amount of tax revenue is targeted to be collected based on the items of expenditures made by the government. In analyzing the effectiveness and tax revenue, exploring the extent of cause-effect relationship between tax revenue and some selected variables is indispensable. So the study outlines the involvement of tax revenue to fiscal policy effectiveness as the extent to which tax revenue can meet the expenditure to reach the fiscal goals.

The research techniques applied to this study is both descriptive and analytical. Only secondary data are used. For secondary data publications of the Ministry of Finance (Bangladesh Economic Review of Different Years) have been used. Data have been collected from the fiscal year 1972-73. But for some dependent variables data are available from the fiscal year 1989-90. A simple linear regression model is applied to establish the relationship of the considered variables.

In the present study, total tax revenue represents the independent variable and the other variables such as government expenditure on payment and allowance, pension and retirement benefits, interest payment (domestic), interest payment (foreign) are treated as dependent variable.

Observation on the Nature of Revenue and Expenditure of Bangladesh Government

Since independence, government of BD is trying to formulate a sound fiscal policy. Both the expansionary and contractionary types of policy have been taken based on the economic scenario of the country. But the prime focuses are on mobilization of domestic resources, increasing investment, fostering economic growth, ensuring socio-economic justice, maintaining macroeconomic stability and reducing dependency on foreign aid. For financing different activities to achieve the mentioned goals, government depends on taxes, non tax revenue, borrowings (within and outside the country) and foreign aid. The prime source of revenue is tax revenue. Now let us have a look on tax, non tax revenue and government expenditure as % of Gross Domestic Product (GDP).

In Bangladesh economy, more than lion-share of revenue is amassed from taxes. Tax revenue as percentage of GDP in FY 2011-12 is 12.56. Gradually this percentage is increasing (Table-1). The particulars of receipts from taxes under NBR (National Board of Revenue) are tax on income and profit, value added tax (VAT), customs duty, excise duty, supplementary duty and others. The tax receipts from non-NBR sources are narcotics duty, motor vehicles tax, land tax and stamp (non-judicial). Non tax revenue is also on increasing trend. The particulars of non tax revenue are different types of fees, tolls etc.

The governments in different countries have taken on various activities for economic development. But there is an open-ended debate regarding the scope, role and size of the government expenditure. Developing country like Bangladesh needs government support. And as laissez-faire economy is only possible in theory, there is the necessity of government activities. Although, privatization is getting more and more emphasis, there are public goods and many other services which must have to be provided by the government. In BD economy, government provides support to health& education sector, infrastrucral development, public administration and defense, public utilities to boost up national income, reducing poverty, widening the potentials of human resource and to enhance macroeconomic stability.

For the above mentioned purpose, government needs increasing amount of financial resources. To finance the activities, government depends on tax revenue at a greater extent. There exists a positive relationship between tax revenue and government expenditure. Increase in government revenue may help the government in increasing government expenditure.

Table-1: Revenue as Percentage (%) of GDP

Year	Total Revenue	Tax Revenue	Non Tax Revenue	Government Expenditure as % of GDP
1991-92	8.0	6.5	1.5	11.6
1992-93	8.8	7.2	1.6	12.0
1993-94	9.1	7.3	1.8	13.8
1994-95	9.3	7.3	2.0	13.5
1995-96	9.3	7.3	2.0	13.1
1996-97	9.5	7.8	1.7	13.0
1997-98	9.4	7.5	1.9	12.7
1998-99	9.0	7.2	1.8	13.3
99-2000	10.0	7.7	2.3	13.8
2000-01	9.60	7.80	1.80	14.75
2001-02	10.21	7.81	2.40	14.92
2002-03	10.35	8.30	2.05	14.00
2003-04	10.63	8.50	2.13	14.17
2004-05	10.57	8.62	1.96	14.54
2005-06	10.79	8.70	2.09	14.20
2006-07	10.58	8.40	2.18	14.30
2007-08	11.30	8.96	2.34	17.48
2008-09	11.25	9.03	2.22	15.31
2009-10	11.5	9.3	2.20	16.0
2010-11	10.21	7.81	2.4	16.49
2011-12	12.56	10.53	2.03	17.62

Source: Bangladesh Economic Review (organized by the author)

Results from Analysis

Equation (a) indicates that if total tax revenue increases by 1crore payment and allowance increases by .26 crore. The value of R about 97% of the variation of the payment and allowance is explained by the total tax revenue.

PaA = 751+0.26TTR ………………………….. (a)
R^2 = 0.978 Sig = 0.000

Where,

PaA = Payment and Allowance made by the government
TTR = Total Tax Revenue collected

Table2: Regression results (for equation a)

Dependent variable	Independent variable	Constant term(a)	Coefficient(b)	R Square	Sig.
Payment and allowance	Total Tax Revenue	751	.260	.978	.000

Equation (b) implies that if total tax revenue increases by 1crore pension and retirement benefit increases by .06crore. The R^2 value implies about 95% variation of pension and retirement benefit is explained by the total tax revenue.

PRB = 26+0.06TTR ……………………………….. (b)
R^2 = 0.95 Sig = 0.000

Where,

PRB = Pension and Retirement Benefit
TTR = Total Tax Revenue

Table 3: Regression results (for equation b)

Dependent variable	Independent variable	Constant term(a)	Coefficient(b)	R Square	Sig.
Pension and Retirement Benefit	Total Tax Revenue	26	0.06	0.95	0.000

From the above results of equation (a),b) and table 2 and 3 following assessments can be made.

The payment and allowance to government employees and the system of pension and retirement benefit (which items of revenue expenditure are spent from tax revenue) can help to enhance economic growth. The following explanation will make it clear how this enhancement of economic growth is achievable. After receiving payment and allowance, the households (government employees) make consumption which is one of the components of aggregate demand (Aggregate Demand = Consumption + Investment + Government Expenditure + Net Exports). In Fiscal Year (FY) 2010-11 the total consumption as percentage of Gross Domestic Product (GDP) is 80.4. Increase in aggregate demand stimulates economic growth. On the other hand, it is common practice to interpret pension and retirement benefit as negative factor in society explaining that a group of people is enjoying certainty in terms of income where people of different classes of society have to go with severe uncertainty. Now, it can be thought in the way that pension and retirement benefit ensures consumption of these retired people. And this consumption obviously contributes to 80 % (consumption as % of GDP). In these circumstances, a look to GDP growth rate is necessary. Aggregate demand hike results in real GDP hike. In FY 2011 growth rate was 6.7%. For the period of FY 1949-50 to FY 1969-70 and FY 1972-73 to 1986-87 growth rate were 3.20% and 4.21% respectively.GDP is increasing at an increasing rate(except some fiscal years). And in the current fiscal year 2012-13 the targeted growth rate is 7.2%. Overtime the real GDP growth rate of Bangladesh economy is in a positive trend in spite of disastrous natural calamities and political instability. From the above analysis the following chain (multiplier effect) can be drawn (Fig.-1).

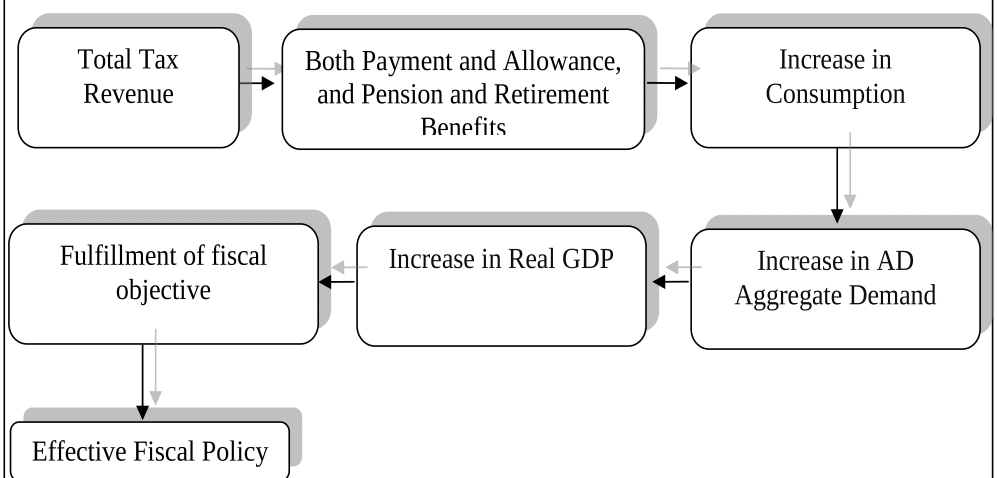

Fig.-1: Multiplier Effect of Tax Revenue

Now, if we look to the employment-unemployment scenario, creating employment opportunity is
oneof the topmost desires of the citizens. Governments of different regimes are trying to engage the unemployed. For their service, tax revenue from the very beginning of the independence is helping to compensate these public sector employees in terms of payment and allowance. From the discussion it can be said that using tax revenue is an effective way to warfare economic troubles such as unemployment, slow growth etc. An attempt to enhance aggregate demand and employment opportunity financed by tax revenue in terms of payment and allowance and pension and retirement benefits renders contribution to meet the fiscal objectives such as economic growth and macroeconomic

stability(in terms of employment creation). As Bangladesh economy cannot achieve potential level of GDP, so there is a need of demand-stimulus. Tax revenue can serve up the purpose as it has a powerful effect on demand, output and employment. So tax revenue is among the most important factors of fiscal policy effectiveness.

$IP_{(D)} = -1145+0.21TTR$ ……………………. (c)

$R^2 = 0.965$ Sig = 0.000

Where,

$IP_{(D)}$ = Interest Payment Domestic

TTR = Total Tax Revenue

Table 4: Regression Results (for equation c)

Dependent variable	Independent variable	Constant term(a)	Coefficient(b)	R Square	Sig.
Interest Payment Domestic	Total Tax Revenue	-1145	0.211	0.965	0.000

Interest payment to domestic lenders is made out of tax revenue. The subsequent explanation will justify how tax revenue is trying to minimize the debt burden of government within the country. Equation (c) implies that if total tax revenue increases by 1crore, interest payment (domestic) increases by .21 crore. R^2 value indicates that 96% variation of interest payment (domestic) is explained by total tax revenue. From equation (c) the co-efficient of total tax revenue (0.21) is acting as a stabilizing force. Because, developing economy like Bangladesh, government has to borrow from the domestic financial system to implement fiscal objectives. Macroeconomic theory suggests that this type of borrowings may results in the effect named as “crowding out” which may undermine GDP growth rate through reduction in private investment originating from low availability of credit in the financial system. Recently, this tendency of borrowing is increasing. In fiscal year 2010-11, borrowing from the money market creates a sort of unrest and liquidity crisis to some lower extent. And in the present budget of fiscal year 2012-13, 17.5% of total financing will stem from internal source which may result in interest rate hike and money market instability. If the loan can be recovered (which is going on), the stability may not be destroyed. To manage this debt, activities have been taken. In revenue budget, interest payment is an item of expenditure. Interest payment to domestic lenders has been made out of total tax revenue. So, tax revenue is supportive to manage the debt burden of government within the country. On the contrary, as domestic private investment is increasing and privatization is getting more and more emphasis from fiscal year to fiscal year, it can be said that tax revenue is working to minimize the crowing out effect. Again, it is worth mentioning that tax revenue is helpful to meet another fiscal objective “Increasing Investment”. The discussion portrays the role of tax revenue to make fiscal policy effective.

$IP_{(F)}$ = 477+0.16 TTR ……………………. (d)
R^2 = 0.918   Sig = 0.000

Where,

$IP_{(F)}$ = Interest Payment Foreign
TTR = Total Tax Revenue

Table 5: Regression Results (for equation d)

Dependent variable	Independent variable	Constant term(a)	Coefficient (b)	R Square	Sig.
Interest Payment Foreign	Total Tax Revenue	477	0.16	0.918	0.000

Interest payment to foreign lenders is made out of tax revenue. The loan is not free of cost. In revenue budget, interest payment (foreign) is an item of expenditure. So, tax revenue is sympathetic to manage the debt burden of government outside the country. Equation (d) implies that 1crore increase in total tax revenue will increase the interest payment foreign by .16 crore. R^2 value indicates 91% variation of the interest payment foreign is explained by total tax revenue. In equation (d), the value of the coefficient of total tax revenue, "0.16" implicates that tax revenue always plays a significant role to reduce dependency on foreign aid. It is mentionable that reducing dependency on foreign aid is one of the fiscal objectives.

Since independence, Bangladesh has received financial assistance in terms of grants and loans. At the initial stage, dependency on foreign resources made some development. But to proceed further, dependency on domestic resources is a must. But, in the present budget for fiscal year 2012-13, 3.2% and 6.5% of total financing will be generated from foreign grants and foreign loans respectively. In future, if Bangladesh cannot pay the loan including interest, the next generation will be in trouble which is not desirable. Continuous dependency will create burden to our next generation. They are not supposed to incur this debt. They will be in vicious circle of burden (Fig.-2). On the other hand, there is the question of image and debt management. Taking foreign loan on a regular basis, nullify the fame of this prosperous country. Again it is forecasted that in future it will be difficult to get loan from the developed world. "Greece" is an example. Euro zone is worried about the crisis of Greece. From 2008 to present the US economy is in economic depression. The African countries are still underdeveloped. In these circumstances, foreign loan for Bangladesh will be less available.

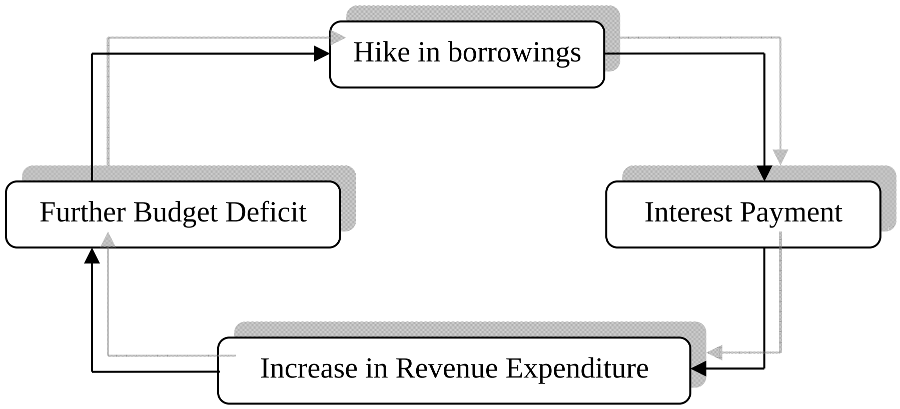

Fig.-2: Vicious Circle of Burden

Conclusion

An attempt has been made in this paper to analyze the contribution of tax revenue to the effectiveness of fiscal policy. The study reveals that there is some noticeable development in the economy in terms of economic growth, macroeconomic stability and management of government debt etc. These development goals are targeted to achieve by fiscal policy. Tax revenue has contributed to the achievement. Bangladesh economy now is in better position than before. But the economy has to walk a long way to achieve further development. As laissez-faire economy is only possible in theory, there is the necessity of government to keep the wheels of the economy moving. In a mixed economy like Bangladesh, proper implementation and coordination of both the fiscal and monetary policy is needed. Government activities exert significant impacts on the economy and tax revenue is helping in many ways. In conclusion, it should be mentioned that, the tax system should be sound, trouble-free and economically competent. Whitening black money must be taxed three times higher than regular rate. Taxpayers are paying more taxes than earlier time periods. But the cost of paying tax in terms of money and time for tax preparation should be lower. For prudent, effective and impartial practice of the recommended tax system and full utilization of tax revenue, good governance in an egalitarian environment is necessary.

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Appendix

The dependent and independent variables are in positive trend (Table-2) from FY 1972-73 to FY 2010-11.

Trend of the Dependent and Independent Variables of the Study

(in Crore Tk.)

Fiscal Year	Total Tax Revenue	Pay and Allowance	Interest Payment (Domestic)	Interest Payment (Foreign)	Pension and Retirement Benefits
1972-1973	173.51	-	-	-	-
1973-1974	297.94	-	-	-	-
1974-1975	514.54	-	-	-	-
1975-1976	804.53	-	-	-	-
1976-1977	750.05	-	-	-	-
1977-1978	1035.63	-	-	-	-
1978-1979	1236.46	-	-	-	-
1979-1980	1407.3	-	-	-	-
1980-1981	1778.07	-	-	-	-
1981-1982	1968.06	-	-	-	-
1982-1983	2159.8	-	-	-	-
1983-1984	2410.1	-	-	-	-
1984-1985	2847	-	-	-	-
1985-1986	3228	-	221.87	206.04	75
1986-1987	3853	-	205	240	95
1987-1988	4367	-	240	350	123
1988-1989	4896	-	250	483	144
1989-1990	5781	2251.3	285.1	377	169.4
1990-1991	6383	2307.4	417.1	437.5	224.1
1991-1992	7741	2810.7	634.4	473.2	340
1992-1993	9030	339.5	550	475	405.2
1993-1994	9880	3598.2	519	584.8	470
1994-1995	11110	3958.2	606.1	600	560
1995-1996	12233	4207.6	1039.7	700	648.4
1996-1997	14074	4391.5	1080	675.5	710
1997-1998	15001	4645	1594	725	782
1998-1999	15855	5100	2221	725	1078
1999-2000	17096	5715	2769	785	1108
2000-2001	19490	5949	3306	820	1399
2001-2002	21930	6801	3585	935	1564
2002-2003	24950	7282	4617	957	1667
2003-2004	28300	7913	4841	1001	1917
2004-2005	31950	8762	5303	1200	2106
2005-2006	36175	10122	6246	1299	2210
2006-2007	39247	12883	7854	1300	2928
2007-2008	48012	13660	10621	1346	3423
2008-2009	55526	15106	12003	1311	3617
2009-2010	63956	17047	13255	1391	3763
2010-2011	79052	20443	13156	1422	4003

Note: - indicates data were not available

Source: Organized by the author from Bangladesh Economic Review, GOB.