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Fiscal Deficits and Growth in Sri Lanka

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ABSTRACT

This paper examines the growth effects of fiscal deficits in the light of policy debates on the Sri Lankan economy during the period 1970 to 2015. More specifically, the study attempts to answer whether persistent increase in fiscal deficits hindered or supported economic growth over the last three decades. If it were concluded that economic growth has been negatively affected by fiscal deficits, then deficits targeting within the Sri Lankan economy becomes extremely important. On the contrary, if fiscal deficits have positively affected economic growth, then controlling the size of fiscal deficits becomes expensive in terms of economic development. Empirical evidence based on the impulse response function showed that increase in fiscal deficits had a negative and significant impact on economic growth, implying that policy makers needed to control high levels of fiscal deficits in order to achieve desired levels of growth. This finding further confirms the presence of neoclassical notion in the context of the Sri Lankan economy. The results also provide an additional argument in favour of expeditiously implementing ambitious strategies for deficits reduction. And failure of implementing ambitious strategies will put an additional burden on fiscal sustainability, which could further undermine growth prospects of Sri Lanka.

KEYWORDS Fiscal deficits; economic growth; openness; Sri Lanka

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