

ECONOMETRIC ANALYSIS OF THE RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE AND ECONOMIC GROWTH IN SRI LANKA

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In the literature of economics, there is a long debate on the relationship between government expenditure and economic growth. In 1890, Adolph Wagner proposed a positive correlation between these two variables. Thereafter, many economists have tried to find empirical support for this relationship. There are two major divergent theories in economics concerning the relationship between these two variables. While conventional Keynesian macroeconomic theory has generally assumed that increased government expenditure tends to lead to high aggregate demand and in turn, rapid economic growth, Wagnerian law which states that national income causes government expenditure mainly through an increase in demand for public services. This study examines the linkage between government expenditures and economic growth of Sri Lankan economy during the period from 1977- 2009. The study tests the validity of the Keynesian view and Wagner's law in the case of Sri Lankan economy.

An assessment of the empirical evidence has been acquired through the co integration, error correction model and the Granger causality tests. This enabled us to search the relationship between government expenditure and economic growth both in the short-run and in the long-run. The empirical findings clearly suggest that there is a statistically significant positive relationship between government expenditure and economic growth existing in the long-run. The Granger causality test shows that causality runs from government expenditure to economic growth and vice versa, the relationship is positive and statistically significant. The empirical analysis in this study support the Keynesian and Wagnerian law that there is a linkage between government expenditure and economic growth and the direction of causality is valid for Sri Lankan economy during the study period. These results have important policy implications for both domestic policy makers and the development partners working in Sri Lanka.

Keywords : Economic Growth, Government expenditure, Co integration, Wagnerian law, Granger Causality test.

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