

## TESTING WAGNER’S LAW AND THE EXOGENEITY HYPOTHESIS OF GOVERNMENT EXPENDITURE: THE CASE OF SRI LANKA (1977-2017)

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The literature in economics points to two main approaches that seek to explain the causal nexus between government expenditure and economic growth. The first is Wagner’s Law and the second is the Keynesian hypothesis. After the open economy policy reforms in 1977, the priority of all successive governments in Sri Lanka has been to improve the island’s economic development and the well-being of the general public. Infrastructure development, employment creation, and poverty elimination were the top-most objectives of government. It is observed that the government public expenditure and real GDP have both increased during the 1977-2017 period. The direction of causality between government expenditure and economic growth is not clear. This study attempts to test the direction of the said causality and the validity of Wagner’s Law and Keynesian hypothesis in the Sri Lankan context. This study is based on annual time series secondary data from 1977 to 2017 and the data series consists of real GDP, real government total expenditure, real government recurrent expenditure, and real government capital expenditure. The data were transformed into natural logarithms to achieve stationarity in variance. Data were extracted from the various publications of the Central Bank of Sri Lanka. The relationship between variables is empirically investigated using the Johansen Co-integration test procedure and the Granger Causality test; here, the views of Keynes and Wagner were also tested. Augmented Dickey-Fuller (ADF) test results indicated that all series are stationary at the first difference. The results of Co-integrating procedure indicate the existence of a long-run equilibrium relationship between government expenditure and economic growth. The results of the Granger Causality test suggest that government expenditure is dependent on and determined by economic growth; the results of this study are therefore more in favour of Wagner’s Law rather than the Keynesian hypothesis. The evidence indicates a unidirectional causality which runs from real GDP growth to total government expenditure in both the short-run and long-run. A unidirectional causality runs from real government recurrent expenditure and capital expenditure to economic growth in the short-run, and we find no long-run causality between those variables in any direction. The present investigation suggests the importance of allocating funds to capital projects and effectively utilizing such funds with the eradication of all types of corruption and wastage.

*Keywords:* Wagner’s Law, Keynesian hypothesis, GDP