

The Impact of Government Debt on Economic Growth in Sri Lanka

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Introduction

Policy makers in Sri Lanka are currently confronted with issues in macroeconomic management and increasing public debt. According to the Annual Report of the Central Bank of Sri Lanka for 2018, the total public debt of Sri Lanka is Rs.11, 977,539 million, or 82.8% of GDP, with domestic debt around Rs.6, 017,992 million or 41.6% of GDP. The total foreign debt of the government is Rs.5, 959,547 million which is 41.2% of GDP (CBSL, 2018). Comparison with previous years indicates that Sri Lanka's government debt is steadily increasing at present, while economic growth is stagnant around 3% - 4 %.

The Government obtains loans from both local financial institutions and foreign sources, as project loans and non-project loans. Government borrowed Rs. 3,149,905 million from foreign sources under project loans and Rs. 2,809,642 million under and under non-project loans (CBSL, 2018). As a result of increase in public debt and debt repayment, Sri Lankan Governments were led unable to allocate resources to various key sectors such as education, health, research and development. Previous studies have found that the domestic debt and external debt have an inverse relationship with economic growth (Atique & Malik, 2012). Expansion of public debt has been found to have a negative impact on economic growth (Chudik *et al.* 2017) and concessionary loans have been found to have a negative impact on economic growth (Fernando *et al.* 2017). In this context, the study of public debt in Sri Lanka is timely important. However, there is a limited literature on understanding the impact of government debt on economic growth. It is in this backdrop that this study is conducted to fill this research gap. This study focuses primarily the impact of government debt on economic growth.

Objective

The main objective of the study is to investigate the impact of government debt on economic growth in Sri Lanka.

Methodology

This study is developed by using a multiple regression model to identify the relationship between government debt and economic growth. The regression model can be described as;

$$\ln EG_t = \beta_0 + \beta_1 \ln \text{CND}_t + \beta_2 \ln \text{IMP}_t + \beta_3 \ln \text{GD}_t + \beta_4 \ln I_t + \beta_4 \ln \text{PDS}_t + \beta_6 \ln \text{PI}_t + u_t \quad (1)$$

In this study, the dependent variable is economic growth (EG) and the independent variables are capital and net debt (CND), imports (IMP), total government debt (GD), investment (I), interest payments on public debt (PDS) and per-capita income (PI). 'u' is the error term and 't' is a time subscript. This study covers the time period 1950 to 2018. The relevant data was collected from annual reports of the Central Bank of Sri Lanka. At the first step of the estimation procedure, ADF and Phillip Peron test are used to check the stationary nature of data. Johanson co-integration test is used to identify the long run relationship and Vector Error Correction Model (VECM) is used to investigate the short run relationship of these variables.

Results and Discussion

The results of the Unit Root Test confirmed that all variables are stationary at their first difference, suggesting that they are integrated in order one. The lag selection criteria suggested one lag as optimal. Johanson Co-integration rank test identified one co-integrating relationship among selected variables with confirming long run relationship. Results of the long run model are as follows;

$$\ln \widehat{EG}_t = -3.40 + 0.34 \ln \text{CND}_t - 0.28 \ln \text{IMP}_t - 0.52 \ln \text{GD}_t + 2.56 \ln I_t - 0.40 \ln \text{PDS}_t + 0.46 \ln \text{PI}_t \quad (2)$$

Note: test statistics of slope coefficients are given respectively as (1.373), (-0.599), (1.637), (4.864), (-2.963), (2.770).

According to the above results, all variables are significant at the 5 % significance level at the long run. Therefore, these results show that cost of

capital and net debt, investment and per-capita income have a long term positive impact on Sri Lankan economic growth. Imports, public debt servicing payments and total government debt have a negative impact on the economic growth in the long run.

Table 1: Vector error correction mechanism

Variable	Coefficient	Std. Error	t-Statistic	Decision
ECM(-1)	-0.320380	0.33097	-0.9802	Insignificant

The estimated coefficient of the error correction term is negative as required by economic theory. From the above, the error correction term coefficient -0.320380 is rightly signed but not statistically significant at 5% level of significance. It indicates that just about 32% of the disequilibrium or distortion in the Sri Lankan economy is yearly being corrected for, though slowly due to the low coefficient of the ECM term.

Conclusion

Even though the government is borrowing, generally it has a positive impact on economic growth. According to this study, it shows that the increase in public debt in Sri Lanka as well as Public Debt Servicing Payments (PDS) have a negative impact on economic growth. The research found that investment, per-capita income and capital and net debt positively affect economic growth. According to the research imports are negatively correlated with economic growth. Therefore, the government should take steps to control imports, and should motivate the domestic producers by providing subsidies. It is only then that Gross Domestic Production (GDP) can be increased. It is necessary to control the depreciation of the exchange rate as it highly affects the servicing of public debt.

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