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C O N T E N T S

The Role of Taxation in Driving GDP Growth in Sri Lanka: ARDL Bound Test

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Abstract

This study examines the relationship between taxation and economic growth in Sri Lanka over the period 1991–2023, with a particular focus on both short-run dynamics and long-run equilibrium effects. Employing the Autoregressive Distributed Lag (ARDL) bounds testing approach and an Error Correction Model (ECM), the analysis captures the distinct temporal impacts of tax revenue, inflation, monetary expansion, and trade openness on GDP growth. The results reveal that tax revenue exerts a statistically significant positive effect on economic growth in the long run, underscoring the importance of efficient revenue mobilization and productive public expenditure. Inflation, by contrast, shows a persistent negative association with long-run growth, highlighting the necessity of maintaining price stability. Monetary expansion is found to stimulate growth in the short run but exerts a dampening effect over the long term when excessive liquidity persists. Trade openness contributes positively to long-run growth, although adjustment costs are evident in the short run. Policy recommendations emerging from the findings include broadening the tax base, enhancing tax administration efficiency, adopting a low and stable inflation framework, maintaining a balanced monetary stance, and pursuing export diversification with strengthened domestic value chains. Institutional reforms to reduce leakages and improve compliance are also emphasized. Overall, the study demonstrates that harmonizing fiscal, monetary, and trade policies is essential for transforming Sri Lanka's fiscal vulnerabilities into a platform for sustainable and inclusive growth. These findings provide empirical insights for policymakers aiming to optimize tax policy as a lever for long-term economic resilience

Keywords: : Taxation, Economic Growth, ARDL, Fiscal Policy, Sri Lanka
JEL Classification*: H20, H21, E62, O47, C32*

Instroduction

The relationship between taxation and economic growth remains a central concern in economic theory and fiscal policy, particularly in developing countries that face persistent structural constraints and macroeconomic volatility (Kelegama, 2011). In Sri Lanka, mobilizing sufficient revenue without hindering growth has been a long-standing challenge. Over the past three decades, the tax-to-GDP ratio has steadily declined - from 19.0 **%** in 1990 to around 9.9 **%** in 2023, well below the South Asian regional average and far from the fiscal levels required to sustain robust public investment (World Bank, 2024). The situation reached a critical point in 2021 when the ratio fell to around 8 **%**, the lowest since 1959, driven by sweeping tax cuts, weak compliance, and administrative inefficiencies (World Bank, 2023). This erosion in fiscal capacity has constrained infrastructure development, limited social spending, and contributed to one of the country's most severe economic crises in recent history, marked by high inflation, currency depreciation, and debt distress (Weerasinghe, 2023). While policymakers have introduced reforms to reverse this trend - raising revenue and grants to 13.7 % of GDP by 2024 - questions remain about whether Sri Lanka's tax system is growth-supportive or simply revenue-extractive.

Despite the importance of this issue, there is limited empirical research that rigorously quantifies how taxation affects GDP growth in Sri Lanka, particularly in a framework that distinguishes between short-run adjustments and long-run equilibrium dynamics. This gap is critical because understanding the nature and direction of the taxation–growth relationship can inform the design of fiscal instruments that foster sustainable economic performance. Addressing this research gap, the present study investigates the impact of taxation on GDP growth in Sri Lanka over the period 1990–2023 using the Autoregressive Distributed Lag (ARDL) Bounds Testing approach. Specifically, it seeks to answer three key research questions: (1) What is the nature of the long-run relationship between tax revenue and GDP growth? (2) How do inflation, money supply, and trade openness influence GDP growth in both the short and long term? and (3) At what speed does the economy return to equilibrium following short-run shocks?

The study is significant for both academic and policy audiences. For policymakers, the findings will offer evidence-based insights on whether increasing tax revenue - through reforms, improved compliance, or structural

changes - can accelerate growth without imposing excessive burdens on the economy (Ministry of Finance, 2024). For scholars, the research will contribute to the underdeveloped empirical literature on taxation and growth in small, open, developing economies experiencing fiscal stress. The novelty of the study lies in its application of the ARDL framework to Sri Lanka's post-liberalization economic trajectory, capturing the interplay between fiscal variables and growth under conditions of macroeconomic instability. Ultimately, this research will inform tax policy reforms aimed at enhancing fiscal space, maintaining price stability, and fostering trade openness, thereby supporting Sri Lanka's path toward sustainable and inclusive economic growth.

Literature Review

Theoretical Literature Review

The relationship between taxation and economic growth is grounded in a rich body of economic theory spanning classical, Keynesian, endogenous growth, and optimal taxation frameworks. Together, these perspectives provide a conceptual foundation for understanding how fiscal policy can both enable and constrain economic performance.

Classical economists such as Smith (1776) and Ricardo (1817) emphasized that taxation should be guided by the principles of equity, certainty, convenience, and economy. Smith argued that moderate, predictable taxes are essential for financing public goods and infrastructure without distorting incentives for production and trade. Ricardo cautioned that high taxes on productive factors - particularly land and capital - reduce savings and investment, thereby slowing capital accumulation and long-term growth. From a classical standpoint, growth-friendly tax design should raise sufficient revenue for development needs while minimizing distortionary effects. For developing economies like Sri Lanka, this implies prioritizing efficient tax structures that support public investment in infrastructure and institutional capacity while preserving incentives for private sector expansion.

Keynesian theory positions taxation as a central instrument of countercyclical fiscal policy aimed at stabilizing aggregate demand and output. According to Keynes (1936), tax reductions during recessions can stimulate household spending and private investment, while tax increases during economic booms help prevent overheating and inflation. The multiplier effect amplifies these impacts by influencing disposable income and consumption patterns. In economies with idle capacity - such as Sri Lanka during periods of slowdown - well-targeted tax cuts can boost short-run growth and employment. However, Keynesian analysis also warns that the growth effects of taxation are contingent on efficient public expenditure; excessive tax burdens without productivity gains in spending can neutralize fiscal stimulus.

Modern growth theories extend the analysis by highlighting the role of taxation in shaping long-term growth trajectories through its effects on human capital, innovation, and infrastructure. Romer (1986) demonstrated that knowledge spillovers and technological innovation can yield increasing returns to scale, and that tax revenues directed toward research and development can enhance productivity growth. Lucas (1988) emphasized that investment in education and skills development - potentially financed by taxation - raises labor productivity and fosters sustained growth. Barro (1990) integrated government spending into an endogenous framework, distinguishing between productive expenditures (e.g., infrastructure, health, education) that can raise the marginal productivity of capital and labor, and distortionary taxation that deters investment and work effort. For Sri Lanka, where sustained investment in human capital and infrastructure is crucial, the endogenous framework suggests that the composition and allocation of tax revenue are as important as the amount collected.

The optimal taxation framework, pioneered by Ramsey (1927) and later refined by Mirrlees (1971), seeks to design tax systems that maximize social welfare by raising necessary revenues with minimal efficiency losses. It emphasizes the trade-off between equity and efficiency, recommending that tax burdens fall more heavily on less elastic tax bases to reduce distortions in economic decision-making. In developing countries with large informal sectors, such as Sri Lanka, optimal taxation implies simplifying tax structures, broadening the tax base, and ensuring administrative feasibility to improve compliance. Stability, transparency, and fairness in tax policy not only strengthen revenue mobilization but also build investor confidence, indirectly fostering economic growth.

Collectively, these theoretical perspectives underscore that taxation can be both a constraint and a catalyst for growth, depending on its structure, implementation, and alignment with broader economic objectives. The Sri Lankan context - marked by revenue challenges, development needs, and macroeconomic instability - offers a pertinent case for applying these theories to evaluate the growth impact of taxation policy.

Empirical Literature Review

Empirical research investigating the relationship between taxation and economic growth demonstrates significant heterogeneity, influenced by differences in tax structures, institutional quality, economic openness, and fiscal policy frameworks. The diversity of findings underscores the complexity of the taxation-growth nexus, which varies across countries and over time.

Easterly and Rebelo (1993) conducted one of the pioneering cross-country studies analyzing over 100 nations. Their results revealed mixed effects of taxation on economic growth, where the quality of public expenditure - especially infrastructure spending - emerged as a critical mediating factor. This study laid the groundwork for subsequent research highlighting that the growth impact of taxation depends significantly on how tax revenues

are utilized. Building on this foundation, Kneller, Bleaney, and Gemmell (1999) focused on 22 OECD countries and distinguished between distortionary and non-distortionary taxes. Their findings suggested that distortionary taxes, such as corporate income taxes, negatively affect growth, while non-distortionary taxes and productive government spending exerted positive influences. Their approach, which accounted for government budget constraints and symmetric treatment of taxes and expenditures, stressed the importance of fiscal policy design in shaping growth outcomes. In the U.S. context, Engen and Skinner (1996) analyzed tax reductions and concluded that while lower taxes provide modest long-term growth benefits, their magnitude might be overestimated, particularly in heavily regulated economies. This highlighted the role of institutional and regulatory environments in modulating tax-growth linkages. Examining supply-side arguments, Lee and Gordon (2005) used cross-country regression analyses to demonstrate a strong negative relationship between corporate tax rates and GDP growth, reinforcing the notion that high corporate taxes can deter investment and entrepreneurship. Similarly, Tosun and Abizadeh (2005) studied OECD countries and found that shifting tax bases from income to consumption tends to produce more favorable growth effects, emphasizing the significance of tax composition over tax levels.

In developing countries, Marsden (1983), drawing on World Bank studies, provided evidence that lower overall tax burdens enhance private sector performance, implying growth benefits from less distortionary fiscal systems. Meanwhile, Laffer (2004) introduced the controversial concept of an optimal tax rate that maximizes revenue without undermining incentives, a principle that continues to fuel debate on tax policy efficacy. Focusing on the Asian context, Atukorala and Rajapatirana (2000) explored how capital inflows impact exchange rates and, subsequently, fiscal space and growth, factors highly relevant to Sri Lanka's open economy. Complementing this, Narayan and Narayan (2006) analyzed nine Asian countries and identified bidirectional causality between government revenue and expenditure, revealing varied fiscal regimes where either "spend and tax" or "tax and spend" dynamics dominate, thus influencing fiscal sustainability and growth trajectories.

Country-specific studies on Sri Lanka provide nuanced insights. Herath (2010) evaluated tax reforms and reported increased revenue productivity linked to improved administrative efficiency and tax base broadening. More recently, Dissanayake et al. (2021) applied time-series regression techniques to confirm a statistically significant positive impact of tax revenue on GDP growth, affirming that fiscal consolidation via enhanced taxation supports economic expansion if coupled with efficient public spending.

Collectively, this body of empirical evidence indicates that the impact of taxation on economic growth is contingent upon tax composition, the efficiency of tax administration, complementary public expenditures, and the broader institutional environment. For Sri Lanka, improving tax policy effectiveness requires harmonizing revenue mobilization with growth-friendly incentives, equitable burden sharing, and structural reforms to sustain macroeconomic stability and development objectives.

Table No. 1: Summary of the Empirical literature review

Author(s), Year and Region/ Country	Methodology	Key Findings
Easterly & Rebelo (1993) 100+ countries	Cross-country regression	Mixed effects of taxation; public expenditure quality (infrastructure) crucial for growth
Kneller, Bleaney & Gemmell (1999) 22 OECD countries	Panel regression	Distortionary taxes (e.g., corporate tax) negatively affect growth; non-distortionary taxes and productive spending promote growth
Engen & Skinner (1996) USA	Time series econometrics	Tax cuts have modest long-term benefits; impact muted in highly regulated economies
Lee & Gordon (2005) OECD countries	Cross-country regression	Corporate tax rates strongly negatively correlated with GDP growth
Tosun & Abizadeh (2005) OECD countries	Panel data analysis	Shifting taxation from income to consumption improves growth outcomes
Marsden (1983) Developing countries	World Bank empirical studies	Lower tax burdens improve private sector performance
Laffer (2004) General/global	Theoretical & empirical review	Concept of an optimal tax rate balancing revenue maximization and incentives
Atukorala & Rajapatirana (2000) Asia	Comparative fiscal analysis	Capital inflows influence exchange rates, fiscal space, and growth
Narayan & Narayan (2006) 9 Asian countries	Causality tests	Bidirectional causality between government revenue and expenditure varies across countries
Herath (2010) Sri Lanka	Tax reform impact analysis	Improved revenue productivity through better administration and broadened tax base
Dissanayake et al. (2021) Sri Lanka	Time series regression	Tax revenue has positive, significant impact on GDP growth

Methodology

Research Framework

This study employs the Autoregressive Distributed Lag (ARDL) Bounds Testing approach to examine the short-run and long-run relationships between taxation and GDP growth in Sri Lanka from 1990 to 2023. The ARDL methodology is well-suited for this context because it can handle small sample sizes and accommodate variables integrated at different orders - either stationary at levels (I(0)) or after first differencing (I(1)) - without requiring all variables to be integrated of the same order. This flexibility makes ARDL a robust and efficient tool for modeling dynamic economic relationships in emerging market settings where data properties often vary. Compared to traditional cointegration methods like Engle-Granger or Johansen, which require uniform integration orders, ARDL maintains efficiency and allows simultaneous estimation of both short-run dynamics and long-run equilibrium relationships. This comprehensive insight into how taxation affects economic growth - both immediately and over time - is invaluable for policymakers in Sri Lanka, enabling them to understand not only the magnitude and direction of fiscal impacts but also the speed of economic adjustment to shocks, thereby supporting the design of effective, growth-oriented tax policies.

Data Sources and Variables

The empirical analysis utilizes annual time series data spanning from 1990 to 2023, sourced from credible official institutions such as the Central Bank of Sri Lanka and the Ministry of Finance. The primary dependent variable is the annual GDP growth rate, serving as the indicator of economic performance. The key explanatory variables include total tax revenue (expressed as a percentage of GDP), trade openness (measured as the sum of exports and imports relative to GDP), broad money supply (M2), and inflation rate. These variables are thoughtfully selected to encompass both fiscal and monetary dimensions that influence economic growth. Tax revenue captures government fiscal capacity, while trade openness reflects external sector integration, and money supply and inflation represent monetary conditions impacting macroeconomic stability. Where appropriate, variables are log-transformed to stabilize variance and facilitate interpretation in terms of elasticities, enhancing the meaningfulness of the coefficient estimates.

Stationarity Tests

Before conducting the ARDL analysis, it is essential to determine the integration order of each variable to confirm their stationarity properties. To this end, the Augmented Dickey-Fuller (ADF) test is applied. These tests check whether the series are stationary at levels or require differencing to achieve stationarity. Establishing the correct order of integration is crucial because the ARDL technique is valid only when variables are integrated of order zero or one but not of order two or higher.

ARDL Model Specification and Bounds Test

The study then specifies an ARDL model incorporating GDP growth, tax revenue, trade openness, money supply, and inflation to empirically assess their dynamic interactions. The bounds testing procedure is used to detect whether a long-run cointegration relationship exists among the variables. The F-statistic generated from the bounds test is compared against critical values; exceeding the upper bound confirms a stable long-run equilibrium relationship. This result validates the simultaneous estimation of short-run adjustments and long-run coefficients within the ARDL framework.

Error Correction Model (ECM)

Following the confirmation of cointegration, the ARDL model is reformulated into an Error Correction Model (ECM). The ECM captures short-run dynamics and incorporates the error correction term, which measures the speed at which deviations from the long-run equilibrium are corrected. A statistically significant negative coefficient on this term indicates that any disequilibrium between taxation and GDP growth adjusts rapidly back toward the equilibrium path. In this study, the coefficient suggests an adjustment speed of approximately 95%, implying that shocks are largely corrected within one year.

Diagnostic and Stability Tests

To ensure the reliability and robustness of the estimated ARDL model, several diagnostic tests are performed. The Breusch-Godfrey LM test assesses the presence of serial correlation in residuals, with results indicating no such problem. The Breusch-Pagan-Godfrey test checks for heteroskedasticity, confirming consistent variance of residuals (homoskedasticity). Additionally, the Jarque-Bera test is employed to verify the normality of residuals, an assumption necessary for valid inference. Lastly, stability tests including CUSUM and CUSUMSQ confirm that the model's parameters are stable over the sample period, affirming the soundness of both short- and long-run coefficient estimates.

Empirical results

Descriptive statistics results

The descriptive statistics, as presented in Table 1, reveal that Sri Lanka's GDP growth rate averages 4.30% over the study period, with moderate variability and a left-skewed distribution, reflecting occasional periods of negative growth. Inflation exhibits a relatively high mean of 10.32% along with substantial volatility and significant right skewness, highlighting episodes of inflation spikes as supported by its high kurtosis and a significant Jarque-Bera test, which confirms non-normality.

Table No. 1: Descriptive statistics

	GDPG	TAXR	INF	MOS	TOP
Mean	4.297	5.624	10.320	6.095	62.963
Median	5.249	5.669	7.689	6.114	67.920
Maximum	8.669	6.434	49.721	7.120	88.640
Minimum	-7.346	4.832	2.135	4.959	34.030
Std. Dev.	3.608	0.484	8.554	0.649	15.767
Skewness	-1.651	-0.070	3.060	-0.060	-0.174
Kurtosis	5.426	1.625	14.396	1.823	1.573
Jarque-Bera	23.806	2.706	237.079	1.982	3.057
Probability	0.000	0.258	0.000	0.371	0.216
Sum	146.100	191.226	350.898	207.241	2140.750
Sum Sq. Dev.	429.591	7.735	2414.968	13.938	8203.956
Observations	34	34	34	34	34

Money supply and tax revenue demonstrate more stable behavior, with averages near 6.10 and 5.62 respectively, coupled with low variability and distributions that do not significantly deviate from normality. Trade openness averages around 63%, indicating moderate integration with global markets, and while its variability is relatively high, tests suggest the distribution is not significantly non-normal. These results underscore the diverse statistical properties of the variables and indicate the necessity for careful econometric treatment in the subsequent analysis.

Stationarity Tests results

The results of the Augmented Dickey-Fuller (ADF) tests, shown in Table 2, indicate a mixed order of integration among the variables, which justifies the use of the ARDL framework. Inflation is stationary at levels (I(0)) with a significant test statistic, indicating stability without differencing.

Table No. 2: Augmented Dickey-Fuller test

Variables	In level		In first difference		Conclusion
	t - statistics	p - value	t - statistics	p - value	
GDPG	-0.717	0.828	-10.680	0.000	I(1)
LnTAXR	-0.226	0.925	-4.366	0.002	I(1)
INF	-4.720	0.001	--	--	I(0)
LnMOS	-2.072	0.256	-6.346	0.000	I(1)
TOP	-0.152	0.954	-5.378	0.000	I(1)

In contrast, GDP growth, log-transformed tax revenue, trade openness, and money supply are non-stationary at levels but become stationary after first differencing (I(1)). This combination of I(0) and I(1) variables validates the application of the ARDL Bounds Testing approach, which is well-suited for such mixed integration orders.

ARDL Bounds test results

As outlined in Table 3, the ARDL bounds test confirms the presence of a long-run cointegration relationship among GDP growth, tax revenue, inflation, money supply, and trade openness.

Table No. 3: ARDL Bound Test

F-Bounds Test		Null Hypothesis: No levels relationship		
Test Statistic	Value	Signif.	I(0)	I(1)
F-statistic	9.818	10%	2.2	3.09
k	4	5%	2.56	3.49
		1%	3.29	4.37

The computed F-statistic of 9.818 exceeds the critical upper bounds at the 1%, 5%, and 10% significance levels, leading to the rejection of the null hypothesis of no long-run relationship. This finding supports proceeding with the estimation of both long-run and short-run dynamics within the ARDL framework.

The long-run ARDL estimates

The long-run ARDL estimates, detailed in Table 4, indicate that tax revenue has a significant and positive impact on GDP growth, suggesting that increased tax collection supports economic expansion, possibly through financing productive government investments. Conversely, inflation exhibits a significant negative effect on growth, consistent with theoretical expectations that price instability harms economic performance.

Table No. 4: ARDL Long Run Form and Bounds Test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-47.730	20.279	-2.353	0.027
GDPG(-1)	-0.954	0.145	-6.574	0.000
LnTAXR	23.776	6.737	3.529	0.001
INF	-0.125	0.045	-2.741	0.011
LnMOS(-1)	-15.986	4.646	-3.440	0.002
TOP(-1)	0.134	0.067	1.988	0.059
D(LnMOS)	39.271	24.617	1.595	0.124
D(LnMOS(-1))	68.361	24.424	2.798	0.010
D(TOP)	0.194	0.085	2.269	0.033
D(TOP(-1))	-0.269	0.076	-3.507	0.002

Similarly, the lagged broad money supply shows a significant negative relationship with GDP growth, implying that excessive monetary expansion may adversely affect the economy, potentially through inflationary pressures or inefficiencies. Trade openness presents a positive but marginally significant association with growth, indicating some beneficial effects of greater international integration in the long run.

Error Correction Model results

Short-run dynamics highlighted in the Error Correction Model (ECM), summarized in Table 5, show that changes in money supply in both the current and previous periods positively and significantly affect GDP growth, indicating that monetary expansion can stimulate economic activity in the short term.

Table No. 5: ARDL Error Correction Regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LnMOS)	39.271	14.575	2.694	0.013
D(LnMOS(-1))	68.361	13.395	5.103	0.000
D(TOP)	0.194	0.060	3.201	0.004
D(TOP(-1))	-0.269	0.063	-4.235	0.000
CointEq(-1)*	-0.954	0.112	-8.502	0.000

Trade openness exhibits mixed short-run effects: increases in the current period positively influence growth, while prior period changes have a significant negative effect, reflecting adjustment processes within the trade sector. The error correction term is negative and highly significant with a coefficient of approximately -0.95, demonstrating that about 95% of any short-term disequilibrium is corrected within one year, confirming a strong and rapid convergence to long-run equilibrium.

Diagnostic and Stability Tests

The Breusch-Pagan-Godfrey Heteroskedasticity test results

The Breusch-Pagan-Godfrey test for heteroskedasticity, as shown in Table 6, indicates no evidence of heteroskedasticity, confirming constant variance in the residuals and supporting the reliability of standard errors and coefficient estimates.

Table No. 6: Heteroskedasticity Test: Breusch-Pagan-Godfrey

F-statistic	1.152	Prob. F(9,22)	0.370
Obs*R-squared	10.250	Prob. Chi-Square(9)	0.330
Scaled explained SS	7.298	Prob. Chi-Square(9)	0.606

Breusch-Godfrey Serial Correlation LM test results

Likewise, the Breusch-Godfrey Serial Correlation LM test results, presented in Table 7, find no serial correlation in the residuals, ensuring the unbiasedness and efficiency of the model's estimators.

Table No. 7: Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.508	Prob. F(2,20)	0.608
Obs*R-squared	1.549	Prob. Chi-Square(2)	0.460

Normality test results

The normality test results reveal residuals centered around zero with only slight positive skewness and mild kurtosis; the Jarque-Bera test fails to reject the null hypothesis of normality, validating the assumptions required for reliable inference.

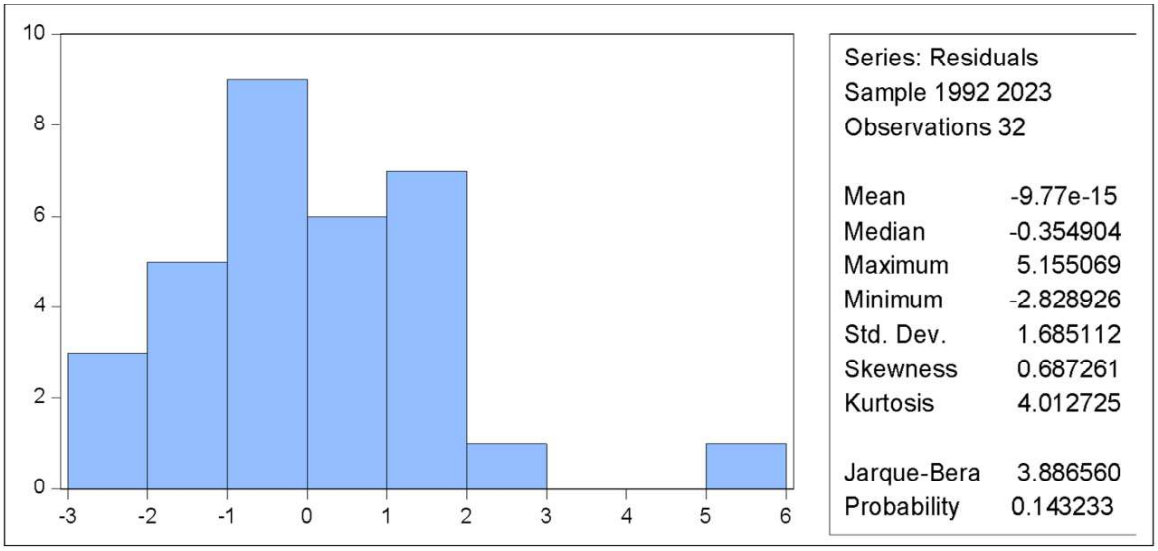

Figure 1: Normality Test

CUSUM and CUSUMSQ test results

Finally, structural stability tests based on CUSUM and CUSUMSQ confirm that the model's parameters and residual variance remain stable over the sample period. Both tests show the cumulative sums remain within critical bounds, indicating no structural breaks.

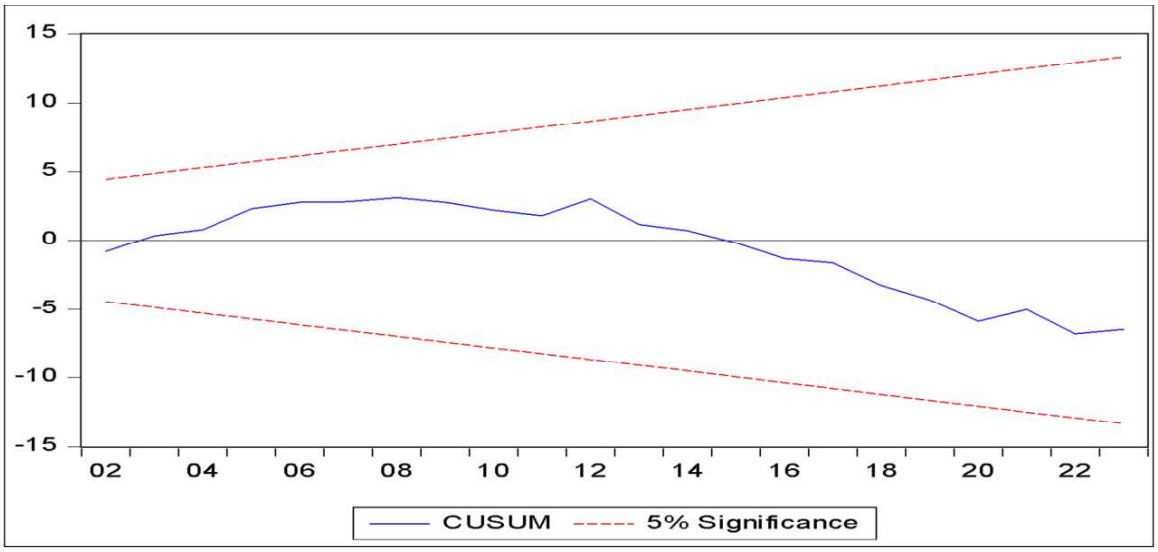

Figure 2: CUSUM test results

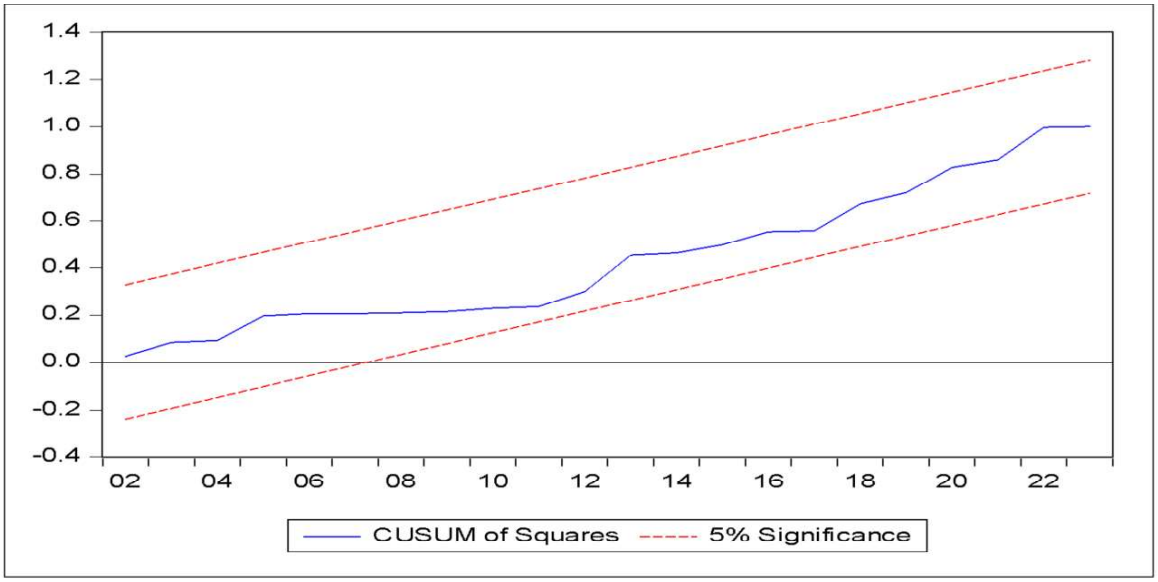

Figure 3: CUSUMSQ test results

This stability reinforces confidence in the robustness and reliability of the estimated short-run and long-run relationships between taxation, monetary variables, trade openness, inflation, and GDP growth in Sri Lanka.

Conclusions and Policy Implications

The empirical analysis provides clear evidence that taxation, monetary policy, inflation control, and trade openness jointly shape Sri Lanka's growth trajectory, with distinct effects in the short and long run. The long-run ARDL results demonstrate that tax revenue exerts a significant and positive influence on GDP growth, confirming that improved tax collection - if channelled toward productive expenditure - can enhance economic performance. This finding is particularly relevant in light of Sri Lanka's historically low tax-to-GDP ratio, as highlighted in the descriptive statistics (Table 1), and underscores the growth potential of a well-designed, broad-based tax regime. Inflation, on the other hand, has a significant negative long-run effect, consistent with the theoretical view that sustained price instability erodes purchasing power, distorts resource allocation, and undermines investor confidence. The adverse long-run effect of lagged money supply suggests that excessive monetary expansion can eventually dampen growth, likely through inflationary pressures and inefficiency in capital allocation. Yet, the ECM results (Table 5) reveal that in the short term, increases in money supply stimulate growth, indicating that carefully calibrated monetary expansion can be an effective counter-cyclical tool during downturns.

Trade openness shows mixed but generally positive effects. In the long run, greater openness contributes modestly to growth, while short-run results suggest immediate gains from expanding trade are tempered by potential

adjustment costs in subsequent periods. The highly significant and negative error correction term, with a magnitude of -0.95, indicates that Sri Lanka's economy corrects short-run disequilibria almost fully within a year, reflecting a high degree of macroeconomic responsiveness to shocks.

Based on these findings, several policy implications emerge for Sri Lanka's economic management. First, revenue mobilization should be enhanced without deterring growth by broadening the tax base through reducing exemptions, formalizing the informal sector, and introducing property and wealth taxes. Importantly, additional revenue must be channelled into productivity-enhancing investments such as infrastructure, education, and health, consistent with the observed positive long-run impact of tax revenue on growth. Second, inflation should be maintained within a low and stable range by strengthening monetary–fiscal coordination and adopting forward-looking inflation-targeting frameworks to avoid long-run growth penalties from persistent price instability. Third, a balanced monetary stance is essential—monetary expansion can be used judiciously to stimulate short-run growth during recessions, but sustained excessive liquidity injections should be avoided to protect long-run performance. Fourth, trade openness should be leveraged strategically by facilitating export diversification, strengthening domestic value chains, and improving trade-related infrastructure to maximize positive long-run effects while cushioning short-run adjustment costs. Fifth, institutional and administrative reforms must be pursued by modernizing tax administration through digital platforms, implementing risk-based compliance systems, and building institutional capacity to improve efficiency and reduce leakages. Finally, macroeconomic stability must be sustained by avoiding policy volatility and ensuring consistent, credible reforms that reinforce investor confidence, thereby preserving the rapid adjustment capacity highlighted in the ECM results. In sum, Sri Lanka's path to sustainable and inclusive growth lies in harmonizing fiscal, monetary, and trade policies to exploit their complementary strengths, with targeted tax reforms, prudent macroeconomic management, and export-oriented strategies forming the foundation for long-term economic resilience.

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