Harnessing Taxation for Economic Growth: An ARDL Analysis of Sri Lanka

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Abstract

Taxation plays a crucial role in mobilizing government revenue and influencing economic growth, yet its growth effects remain inconclusive, particularly in developing economies. This study investigates how taxation can be harnessed to support economic growth in Sri Lanka over the period 1991–2024, while incorporating key macroeconomic determinants including inflation, money supply, and trade openness. The analysis also accounts for the effects of the COVID-19 pandemic and the 2022 economic crisis. The study employs the Autoregressive Distributed Lag bounds testing approach and the Error Correction Model to investigate both long-run and short-run dynamics. The results confirm the existence of a stable long-run relationship among the variables. Tax revenue has a positive but statistically insignificant effect on economic growth in the long run, suggesting that taxation alone is insufficient to promote sustained growth without efficient revenue utilization. Trade openness exerts a positive and significant impact on growth, while money supply negatively affects economic performance. Inflation is found to be statistically insignificant. The findings further reveal that both the COVID-19 pandemic and the 2022 economic crisis have detrimental effects on economic growth, highlighting the vulnerability of Sri Lanka's economy to major shocks. In the short run, taxation positively and significantly influences growth. The Error Correction Model coefficient of −0.635 indicates that approximately 63.5 percent of short-run disequilibrium is corrected within one period. The study recommends strengthening tax administration, improving the productive use of public revenue, maintaining macroeconomic stability, promoting trade openness, and enhancing economic resilience to future shocks. The findings suggest that taxation can contribute to economic growth when supported by effective fiscal management and a stable macroeconomic environment.

Keywords: *Economic growth; Inflation, Money Supply, Taxation, Trade Openness*

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