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PAPER

The Dynamic Interrelationship between Defense Expenditure and Debt in Sri Lanka

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There has been much concern in the relevant literature about the possible destructive economic effects of large military expenditures. It is supported by academics and scholars that defense expenditure can significantly affect a country's economic growth and in some cases it influences external and internal debt. However, relevant empirical studies have produced contradictory evidence while the literature in this field remains relatively poor. Since independence, Sri Lanka has taken several steps to build up its economy in a successful way. At the same time, the country suffered nearly three decades of civil war and heavier defense burden during this time. Military expenditure was very low before the 1980s, but since then a need for foreign borrowing and external debt accumulation grew. Therefore, there should be a possibility relation between the deficits and foreign borrowing in Sri Lanka.

Military spending affects the stock of external debt through many channels; for instance, rapid increase in military spending raises volume of external debt by pressing budget revenues which increases the government borrowing from internal and external sources of finance and increases the debt responsibility in the country (Karagol, 2006). An increase in debt services is linked with high level of external debt which limits investment and capital formation that in turn slows down the rate of economic growth.

The main objective of this study is to investigate the dynamic interrelationship between defense expenditure and debt problem in Sri Lanka for the period from 1983 to 2011. Data for this study have been collected from the Central Bank Annual Reports.

The results show that defense expenditure, domestic debt, and foreign debt are on an upward trend, and foreign debt growth started to go upward since 2000. The massive increases of defense expenditure cause several harmful effects on macroeconomic variables. The results reveal that a rise in military expenditures increases the domestic debt and stock of external debt. The reductions in military spending will reduce the debt problem and will shift resources to developmental projects and stimulate the pace of economic growth. This study invites policymakers to approach the problem of curtailing debt in innovative ways in Sri Lanka.