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**Is There a Conflict between Growth and  
Welfarism? The Tale of Sri Lanka**

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# IS THERE A CONFLICT BETWEEN GROWTH AND WELFARISM?: THE TALE OF SRI LANKA

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## I. INTRODUCTION

Ever since the strategy of 'growthmanship' fell into disrepute towards the end of the 1960s, several new ideas have emerged to take its place; for example, the basic needs strategy, the strategy of growth with redistribution, and the more recent ideas such as the strategy of support-led security (Drèze and Sen, 1989) and the human development strategy (UNDP, 1991). These new ideas have at least one thing in common: they all advocate 'welfarist' intervention by the state, principally in the form of free or subsidized provision of such basic needs as primary health care, basic education, and food and shelter, to its people.

Among the arguments that are offered in support of the new strategies, two are most important. First, it is claimed that welfarist interventions can improve the living standards of the masses within a relatively short period of time, while exclusive reliance on growth to deliver the goods may involve an unacceptably long haul. Secondly, it is also suggested that the quick gains in living standards that can be achieved in this manner may involve little or no loss of growth, if the nature and level of public intervention is judiciously chosen (Streeten *et al.*, 1981, Drèze and Sen, 1989).

All this makes the welfarist path sound very appealing. If intervention can bring quick relief to the poor, and if it can do so without sacrificing growth, what could possibly count against this strategy? The sceptic could raise the little matter of evidence, however. The theory is fine, he might say, but is there any actual experience of countries making rapid gains in living standards through welfarist interventions, and doing so without making

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unacceptably large sacrifice of long-term growth? After all, one could point out that in its heyday the strategy of growthmanship too seemed fine in principle<sup>1</sup>; it was only the actual evidence of its failure to reduce poverty that brought the strategy into disrepute. What then is the evidence for the alternative strategy?

There is a genuine problem here. Unlike in the earlier days when country after country embarked on the path of planned economic growth, very few have attempted the welfarist path. The sample is thus much too small to draw any firm conclusions.<sup>2</sup> But the problem is deeper than that. Even in the case of those countries which are known to have attempted the welfarist path, the lesson is far from being unambiguously clear. The country that has been most discussed in this context is Sri Lanka -- it has been seen by many as a shining example of the wonders that a judiciously chosen welfarist path can do, while others have seen it as a dire lesson in the follies of welfarism.

Our objective in this paper is to take a fresh look at the Sri Lankan experience with a view to forming a clearer judgement as to the lesson it offers. This reappraisal leads to the conclusion that Sri Lanka is indeed a successful case of the welfarist strategy, success being defined in terms of the two appealing features of the welfarist strategy mentioned earlier -- namely, the ability to improve living standards much faster in the short run than would otherwise be possible, and to do so without a large sacrifice of long-term growth.

We begin by providing, in section II, a brief background of the controversy surrounding the Sri Lankan experience. The next three sections take up for examination three different lines of arguments typically advanced by the sceptics. These arguments can be described briefly as follows: (1) *the irrelevance of welfare measures argument*: it says that the high living standards enjoyed by the Sri Lankan people owe very little to welfarist measures; (2)

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<sup>1</sup> There is a perception among certain quarters that the fashion of growthmanship that was in vogue in the 1950s and 1960s was concerned primarily with promoting growth for its own sake, and not with elimination of poverty or the promotion of human development, etc. But as a description of the motivation, as distinct from the actual achievements, of growthmanship, this is not quite true. See, Srinivasan (1993) for more on this.

<sup>2</sup> Drèze and Sen (1989) discuss several of these cases.

*the short-run trade-off argument*: it says that whatever may have been gained by the welfare measures, more could have been gained in the short run by reallocating resources towards growth; and (3) *the long-run trade-off argument*: it says that whatever may have happened in the short run, Sri Lanka's long-term growth prospects were seriously impaired by its welfarist policies, so that taking a longer time perspective the impact on living standards may well have been adverse. We take issue with each of these lines of argument, and then suggest the view (in section VI) that the Sri Lankan experience offers a lesson not so much in the conflict as in the complementarity between growth and welfarism. The final section brings together the main conclusions.

## II. SRI LANKA, THE 'OUTLIER'

The *Human Development Report* of the UNDP calculates every year what it calls the Human Development Index, or the HDI for short, to measure the living standards of people in different countries. This index is essentially a weighted average of per capita income and certain basic capabilities such as literacy and life expectancy<sup>3</sup>. In its 1991 Report, 160 countries from all over the world were ranked in terms of both the HDI index and per capita income, and the difference between the two ranks were calculated for each country. It turned out that Sri Lanka had the second largest difference between the HDI-rank and the income-rank, which implies that relative to income its achievement in terms of living standards is the most outstanding among all countries, except one (China).

This exceptional feature of Sri Lanka's living standards has been well-known for quite some time now, especially through the works of the World Bank (1978), Fields (1980), Isenman (1980) and Sen (1981). In his pioneering work, Isenman (1980) ran a cross-country regression linking various measures of living standards with per capita income of a large number of countries as obtaining around 1975, and found that if this cross-country relationship were used to predict Sri Lanka's living standards on the basis of its per capita income, then the predicted values remained well below the

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<sup>3</sup> See Sen (1985) on the concept of capability and its relevance for the assessment of human welfare.

observed values. To put it differently, Sri Lanka's living standards were way above those prevailing in other countries at similar levels of income, and at par with those at a much higher level of income. Since then, it has become common to describe Sri Lanka as a positive 'outlier' in cross-country relationship between income and living standards.

Despite the numerous weaknesses of international comparative statistics, the statistical fact of Sri Lanka's 'outlier' status (at any given point in time in the recent history) has not been questioned. What has been questioned, though, is the interpretation of this fact -- specifically, the lessons one can draw from it about the conduct of economic policy. It is this debate on interpretation that concerns us here.

The early detectors of the 'outlier' status were quick to attribute it to Sri Lanka's long history of direct interventions in the fields of food, health and education.<sup>4</sup> Since the second World War till the late 1970s, the Sri Lankan people have been provided by the state with a subsidised food rationing system, covering almost the entire population. Beginning even earlier, especially after the malaria epidemic of 1935, the state has also intervened directly in the field of health care. Since Independence in 1948, free primary health care has been provided to all through an extensive network of rural clinics run mainly by paramedics but supported by a strong referral service manned by highly trained doctors. Intervention in education dates back even earlier, quite early in the present century; its scope gradually expanded throughout the century, and soon after Independence free education was made available to all, up to the highest level of university education.

Government expenditure on these three fields rose phenomenally after Independence, especially as the Korean boom inflated the exchequer by raising the tax revenue from the country's leading export crops. Since about the mid-1950s till the end of 1970s, total welfare expenditure has accounted for 8 to 12 per cent of GDP and 30 to 40 per cent of total government expenditure. Sen, Isenman and others have argued that it is this long history of exceptionally wide-ranging intervention in social spheres that explains

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<sup>4</sup> The historical evolution of welfare policies in Sri Lanka has been discussed by Alalima (1985) and Anand and Kanbur (1991), among others.

why Sri Lanka has achieved far higher living standards compared with other developing countries at similar or even higher levels of income.

Sen has in fact noted that apart from Sri Lanka, there are also a number of other countries -- viz. China, Cuba, Vietnam, Chile, Costa Rica, and a few others -- who all share the feature of being 'outliers' (i.e., having living standards far above what is expected given their income levels) and also being particularly active with direct intervention in social spheres (Sen, 1981, Drèze and Sen, 1989). In the terminology developed by Drèze and Sen (1989), all these countries have followed the strategy of 'support-led security' as opposed to the more common strategy of 'growth-led security' which other countries have tried to pursue with varying degrees of success. Their common experience seems to confirm that public interventions can enable a country to bring about significant improvement in the basic capabilities of its people relatively quickly, without waiting for the growth of income to deliver the goods in the long haul of time. This is the lesson that has typically been learnt from the experience of Sri Lanka and other 'outliers'.

But there are detractors of Sri Lanka's achievements who have argued that perhaps the wrong lesson has been learnt from its experience. They maintain that Sri Lanka would have done even better by adopting the strategy of growth-led security. In order to appreciate the precise nature of their arguments, it will be useful to distinguish three different strands of the critique. .

In the first place, it has been suggested that the outlier status of Sri Lanka is explained by factors other than welfare expenditure. Sri Lanka has presumably been blessed with some special feature, not available to other countries, which had acted in its favour. If this is true, then surely her exceptionally high level of welfare expenditure has been to no avail; and her people would have been better off if all those resources were devoted to investment and growth. We may call it the 'irrelevance of welfare measures' argument.

Secondly, even if it is granted that Sri Lanka's outlier status owes itself to her welfare policies rather than to some providential circumstances, it still does not follow that the welfarist strategy was superior to the strategy of growth-led security. It can be shown that the outlier status may in principle



emerge even when welfarism is in fact the inferior option, in the sense that a rupee spent on welfare measures raises living standards *less* in the short run than a rupee spent on investment for growth. If this is true for Sri Lanka, then surely it must be accepted that whatever she may have gained by following the welfarist path, she would have done even better by leaning towards growth. We shall call it the 'short-run trade-off' argument.

Thirdly, even if it is granted that the outlier status genuinely reflects the superiority of welfare expenditures over growth in raising living standards in the short run, the strategy of welfarism can still be criticized from the perspective of long-term welfare. It can be argued that the short run advantage will soon be dissipated, because the cumulative effect of sacrificed growth will eventually make it impossible to sustain high levels of welfare expenditure. The point simply is that, sooner or later, there won't be enough money in the kitty to pay for welfare, as the level of expenditure rises with the growth of population. Meanwhile, other countries, which had opted not to sacrifice growth and thus accepted slower improvement in living standards in the short run, will steal a march over the welfarist country. It is not only that higher levels of private income will enable their citizens to improve their living standards directly, their governments will also have more resources at their disposal to undertake welfarist interventions for the needy. In other words, this is the classic case of the hare and the tortoise, in which the latter eventually wins; more prosaically, though, we shall call it the 'long-run trade-off' argument.

All three lines of argument are either explicit or implicit in the objections raised by the critics to the conventional interpretation of Sri Lanka's experience. In what follows, we shall examine each of them in turn.

### III THE 'IRRELEVANCE OF WELFARE MEASURES' ARGUMENT

#### *The Conventional Interpretation of the Outlier Status*

It will be useful to begin with a short formal presentation of the conventional interpretation of Sri Lanka's outlier status. Taking  $L_j$  as a measure of living standard (say, life expectancy) and  $Y_j$  as per capita income

of country  $i$ , the cross-country regression run by Isenman (1980) can be written as follows:

$$L_i = \alpha + \beta Y_i + e_i \quad (3.1)$$

Using the subscript  $s$  to denote Sri Lanka, the predicted value of its life expectancy corresponding to its income level is given by

$$L_s' = \alpha' + \beta' Y_s \quad (3.2)$$

It has been observed that  $L_s' > L_s$ , and the difference has been found to be statistically significant. Roughly speaking, this means that the error term ( $e_i$ ) is much larger for Sri Lanka than for other countries at about the same level of income. This confirms that Sri Lanka is an 'outlier'.

But what is it that has made Sri Lanka an 'outlier'? The conventional answer singles out the history of large-scale welfare expenditures incurred by successive Sri Lankan governments. The underlying logic of this answer can be explained formally as follows. Notice first of all that equation (3.1) involves a mis-specification, because the living standard depends on both income and welfare expenditures ( $W$ ). The 'true' equation is,

$$L_i = \alpha + \beta Y_i + \gamma W + v_i \quad (3.3)$$

where, the error term is now  $v_i$  instead of  $e_i$ , and the two are related as follows:

$$e_i = \gamma W_i + v_i \quad (3.4)$$

Now recall that the outlier status implies that the error term  $e_s$  is exceptionally large for Sri Lanka; and eqn (3.4) tells us that this must be because  $W_s$  is exceptionally large relative to average  $W$  (because  $v_i$  is assumed to be distributed with zero mean). It is thus that Sri Lanka's outlier status is explained in terms of its welfare expenditures.

But Bhalla (1988a, 1988b) and Bhalla and Glewwe (1986) have recently challenged this conventional interpretation.<sup>5</sup> In terms of the above equations, their objection can be stated in the form of the following suggestion: even equation (3.3) does not represent the true relationship, because apart from income and welfare expenditures there may also exist some special features of a country which might affect its living standards. Denoting such country-specific feature by  $\lambda_i$ , the true relationship is given by

$$L_i = \alpha + \beta Y_i + \gamma W_i + \lambda_i + u_i \quad (3.5)$$

Comparing (3.5) with (3.1), we now get the following equation for the error term  $e_i$ , instead of eqn (3.4)

$$e_i = \gamma W_i + \lambda_i + u_i \quad (3.6)$$

This equation immediately shows that it may be a mistake to explain the outlier status in the conventional way. For instance, the coefficient  $\gamma$  may be zero, in which case welfare expenditures would not add to living standards at all, and yet Sri Lanka might be found to have a large value of  $e_s$  simply because of a large value of  $\lambda_s$ . Thus while it may be true that Sri Lanka's welfare expenditures are exceptionally large, and while it may also be true that Sri Lanka is an outlier, there may not exist any causal connection between the two.

This has been a negative criticism so far, casting doubt on the conventional practice of giving credit to welfare expenditures for Sri Lanka's exceptional living standards. But the Bhalla-Glewwe criticism goes further. They also try to establish that it is indeed a special feature rather than welfare expenditures that deserves most of the credit; it is a mere coincidence, in their view, that welfare expenditure also happens to be large. One may note that, even before examining this proposition closely, its credibility begins to strain as soon as one recalls that there are several other countries apart from Sri Lanka who happen to be similar outliers and who are also distinguished for their extensive intervention in social welfare. It would be too much of a coincidence if each of these cases were to be explained by some country-

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<sup>5</sup> Their challenge has inspired a lively debate, to which the present paper is also intended to contribute. For other major contributions to this debate, see Ravallion (1986), Isenman (1987), Pyatt (1987), Sen (1988), Anand and Kanbur (1991), and Anand and Ravallion (1993).

specific feature, with welfare expenditures playing no or little role. Nevertheless, it is worth examining the Bhalla-Glewwe argument in the specific case of Sri Lanka.

Their strategy is composed of two parts. First, they try to show that welfare expenditures have been pretty useless in Sri Lanka after all, which implies that the coefficient  $\gamma$  in eqn (3.6) is not statistically significant from zero. Secondly, they identify a special feature - unique to Sri Lanka -- that is supposed to provide the alternative explanation of its outlier status.

### *Ineffective Welfare Expenditures?*

The first part of the strategy, which tries to show the ineffectiveness of welfare expenditures, involves carrying out a different cross-country regression from the one done by Isenman. The idea is to do the regression in a manner that will eliminate the special feature  $\lambda_i$  from the error term, because if Sri Lanka turns out to be an outlier even after such elimination, then welfare expenditures may be given some credit, otherwise not. Bhalla eliminated  $\lambda_i$  by considering the *change* of living standard over time instead of its *level* at a point in time. By denoting change with the prefix  $\Delta$ , and noting that  $\Delta\lambda_i = 0$  because the 'special feature effect' is assumed not to change over time, eqns (3.3) and (3.5) are converted respectively into

$$\Delta L_i = \beta \cdot \Delta Y_i + \Delta e_i \quad (3.7)$$

$$\Delta L_i = \beta \cdot \Delta Y_i + \gamma \cdot \Delta W_i + \Delta u_i \quad (3.8)$$

so that

$$\Delta e_i = \gamma \cdot \Delta W_i + \Delta u_i \quad (3.9)$$

Now, if a cross-country regression is run using the change-change equation (3.7) instead of the level-level equation (3.3), we can see from eqn (3.9) that the residual will no longer be 'contaminated' by the effect of the special feature, if there is any. So if a country happens to have a large residual (i.e., if it turns out to have an outlier status) in this regression, one would be able to attribute it convincingly to welfarist interventions. But when Bhalla (1988a) carried out this regression for the period between 1960 and 1978, he found that Sri Lanka was no longer an outlier, i.e.  $\Delta e_s$  was

found to be quite unexceptional. From this he concluded that conventional wisdom may have been mistaken in identifying welfare expenditure as the cause of Sri Lanka's high living standards.

There is however a logical gap in this argument. In order to establish the ineffectiveness of welfare expenditures, it is necessary to show that the coefficient  $\gamma$  (in eq (3.6)) is not significantly different from zero. But one cannot discern anything about  $\gamma$  from Bhalla's demonstration of an 'unexceptional'  $\Delta e_S$ , in the absence of some additional information. It can be seen from eqn (3.9) that an 'unexceptional'  $\Delta e_S$  means in the first instance that  $\gamma \cdot \Delta W_S$  is unexceptional; but the latter can come about in two distinct ways: either because (i)  $\Delta W_S$  is large and positive but  $\gamma$  is close to zero, or because (ii)  $\gamma$  is large and positive but  $\Delta W_S$  is unexceptional. Therefore, the inference of insignificant  $\gamma$  will only follow if there is some independent information that  $\Delta W_S$  was exceptionally large in the period under consideration.

But Bhalla has produced no such information. In fact, in his original paper (Bhalla, 1988a), there is no mention, let alone evidence, about the *change* in welfare expenditure in Sri Lanka over the 1960-78 period. The only evidence he draws upon relates to expenditure *levels*. Thus he argues "Given that social welfare expenditures in Sri Lanka have been assumed to be larger than average, these results cast a somewhat different light on Sri Lanka's welfare policies than that concluded by earlier authors." (Bhalla, 1988a: 107)

But as Sen (1988) has correctly pointed out, Bhalla was not justified in drawing inference about a change-change relationship from a level-level comparison. It has to be established that the *change* in welfare expenditures was exceptionally large in Sri Lanka as compared with other countries during the 1960-78 period. In response to this criticism, Bhalla has subsequently tried to produce some evidence about the *change* of expenditures (Bhalla, 1988b, Bhalla and Glewwe, 1986), but not with much success. He has noted, for example, that the real per capita welfare expenditures went up by over 50 per cent between the 1950s and the 1960s, and has reasserted on this basis his earlier position that the "post-1950s splurge in social welfare spending was not particularly effective" (Bhalla, 1988b: 563).

But even this won't do, because it is not enough to show that Sri Lanka's welfare expenditure increased after 1960; it needs to be shown that this increase was significantly higher than in other countries.<sup>6</sup> This is precisely what Bhalla has not shown. In fact, Sen has suggested the contrary view that the *change* in welfare expenditures in the post-1960 period was quite unexceptional in Sri Lanka, the truly exceptional expenditures having been incurred during the earlier era, which is why one finds no *exceptional change* in her living standards after 1960. In other words, what is revealed by Bhalla's change-change relationship, is not the inefficacy of welfare expenditures but merely the fact that Sri Lanka ceased to be exceptionally welfarist *at the margin*.

To be fair, though, it must be admitted that this particular debate on what has happened at the margin remains somewhat inconclusive due to limitations of data: comparable international data on welfare expenditures simply do not exist for the pre-1970 period.<sup>7</sup> So if Bhalla has failed to produce the relevant evidence, it is not for want of trying. But then one has to accept the implication of this limitation and resign to the fact that, for the period concerned, the change-change relationship cannot be used to judge the efficacy of welfare spending in Sri Lanka, or in any other country for that matter.<sup>8</sup> Thus the first part of Bhalla's strategy, which purports to show that welfare spending was ineffective in Sri Lanka (at least after 1960), must be seen to have failed.

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<sup>6</sup> Note that armed only with the fact of *increased* expenditure in Sri Lanka, without reference to other countries, one could still legitimately doubt the efficacy of welfare expenditures if living standards had not improved at all in Sri Lanka after 1960. But that is not the case -- for instance, life expectancy went up from 62 years in 1960 to 69 years in 1975 and infant mortality rate fell from 57 to 45. So the inference of inefficacy can only be drawn if *exceptional* increases in welfare spending can be shown to have resulted in *non-exceptional* improvements in living standards. There is thus no way of avoiding comparison of increased spending in Sri Lanka with that of other countries.

<sup>7</sup> Bhalla and Glewwe (1986: 49)), however, venture the guess that "given the percentage increase in real expenditures observed for Sri Lanka during the post-1950s time period, it is likely that such expenditure changes were greater than average." Everyone is of course entitled to make informed guesses in the absence of solid data, provided however that one doesn't expect others to take them on trust.

<sup>8</sup> However, as we shall presently see, later studies have resolved the issue for Sri Lanka using a different technique and a different set of data.

### *The Special Feature Effect*

But one still has to reckon with the second part of the strategy, which is to attribute Sri Lanka's high living standards to some special feature of the country. After all, if her superiority can be explained largely by the presence of this special feature, which is supposed to be unrelated to welfare expenditures, then notwithstanding the inconclusiveness of Bhalla's change-change regression, one must still reject the conventional interpretation of Sri Lanka's outlier status. It is therefore necessary to consider the plausibility of what Bhalla takes to be the special feature of Sri Lanka.

It may be recalled that the 'special feature effect' was introduced by Bhalla as an 'initial condition' in his change-change regression for the 1960-78 period. The idea was that any superiority Sri Lanka may have had over other countries prior to 1960 was to be seen as a consequence of the special feature rather than of welfare policies. But what is this special feature? Bhalla gives a general description of the initial condition as follows: " $\lambda_i$  is a country specific and time-invariant 'fixed-effect' representing such factors as its climate, diet, technological change (e.g., the malaria eradication programme of 1946), etc." (Bhalla, 1988b: 558) Since, he does not mention any particular advantage for Sri Lanka as regards diet or climate, we must take it that the special feature he has in mind is the malaria eradication programme which was launched in 1946, with tremendous success. The special feature argument then boils down to the following proposition: the exceptionally high life expectancy and low infant mortality that one finds in Sri Lanka today is not the result of welfarist policies but of the malaria eradication programme of nearly half a century ago.

In our view, however, this argument does not suffice to debunk the welfarist policies of Sri Lanka. One will have to show that the so-called special feature itself was neither a part nor a consequence of welfare policies adopted in the past. Otherwise, singing the praise of the special feature will amount to singing the praise of welfare policies. It turns out that, despite protestations to the contrary, this is precisely what Bhalla ends up doing.

Conscious of the need to steer clear of welfare policies, Bhalla characterises his chosen special feature -- the malaria eradication

programme of 1946 -- as a 'technological change'. But this is curious. The programme cannot be seen as a purely exogenous technological change falling like manna from the heaven; it was in fact a part and parcel of Sri Lanka's continuing policy of expanding the health facilities for all, which had started more than a decade earlier. After all, the technology used for this programme was not a secret known only to the Sri Lankans. It was a simply technology, involving the use of DDT -- an insecticide developed in the West, and available to any country that was willing to pay for it. If Sri Lanka derived any special benefit out of it, it was only because her health expansion programme was already in place to take advantage of it. Policy, rather than Providence, was the key.

There is a further reason why the special feature effect cannot be dissociated from welfare policies. Regardless of how one characterises the malaria eradication programme, one has to recognize that Sri Lanka's superiority over other countries prior to 1960 cannot be explained mainly in terms of this programme. A great success as it was, this programme accounted for only a small part of the spectacular improvements that occurred in the health status of the Sri Lankan people during that period. The most careful assessment of the programme made to date shows that it can explain only about 20 to 25 per cent of the improvement in the death rate that took place between 1936-45 and 1956-60 (Gray, 1974). Obviously, the entire welfare programme consisting of health, education and food distribution policies must be given credit for the achievements of this period.<sup>9</sup>

Thus the strategy of debunking welfare policies by presenting Sri Lanka's outlier status as an 'initial condition' and then equating that initial condition with some technological change, unrelated to welfare policies, does not simply work. In the first place, the so-called special feature is itself a part and parcel of Sri Lanka's history of welfarism; and secondly, there was more to Sri Lanka's early achievements than the effect of the special feature. Therefore, even if one accepts that the impact of welfare policies of the post-1960 period remains inconclusive, one cannot escape the conclusion

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<sup>9</sup> Elsewhere, Bhalla seems to admit this fact; e.g. "These 'fixed effects' may also arise because of past policy." (Bhalla and Glewwe, 1986: 38). He does so without admitting, however, that to explain the special feature in terms of past policies is to give the game away!



that it is the 'long history' of Sri Lanka's welfarism that accounts for its 'outlier status'.<sup>10</sup>

#### IV. THE SHORT-RUN TRADE-OFF ARGUMENT

The preceding argument establishes that the high level of welfare expenditure incurred by the state was not a 'wastage' after all; it did contribute to raising the living standard to exceptionally high levels. But the question still remains: couldn't Sri Lanka have done even better by diverting resources from welfare expenditures to investment for growth? In order to answer this question, one will have to assess the nature of the trade-off between the two types of expenditures in terms of their impact on living standards. But before addressing this question, it will be useful first to dispel a common misperception. It is commonly believed that the very fact of Sri Lanka's 'outlier' status resolves this question in favour of welfarism; in other words, the 'outlier' status is interpreted to indicate that Sri Lanka has done better by following the welfarist path compared to what she could have achieved by diverting resources to income growth. But this interpretation does not necessarily follow. This is because the pursuit of welfare policies can turn a country into an outlier in two entirely opposite ways -- and only one of them can be described as favourable to welfarism.

In the usual interpretation, the process through which a welfarist country becomes an outlier is believed to be as follows. Welfare expenditures

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<sup>10</sup> It is indeed this 'long history' proposition that earlier authors such as Sen and Isenman had offered as the explanation of Sri Lanka's 'outlier' status. But Bhalla has raised a messy controversy by attributing to them the view that the credit goes mainly to the *recent* (meaning post-1960) welfare expenditures. Apparently, he was misled by Sen's (1981) inter-country comparison in which he estimated the change in living standards between 1960 and 1978 in order to identify the outstanding performers for this period, and found Sri Lanka to be one of them. But Bhalla failed to notice that although Sen commended Sri Lanka's performance in this period, he nowhere suggested that it was this particular period's performance that accounted for its outstanding status in the recent years. On the contrary, Sen's own estimates show that for this particular period Sri Lanka ranked quite low among the top performers (for example, its improvement in life expectancy was exceeded or equalled by seventeen other countries), and he specifically mentioned that already by 1960 Sri Lanka had exceptionally high standards (p.295). Be that as it may, for our part the issue we are concerned with at this stage is whether Sri Lanka's 'outlier' status can be explained away by invoking some special feature or whether one ought to give credit to welfare expenditures. In this context, it is the 'long history' proposition that matters.

add to living standards much more than what is subtracted from it by the sacrifice of growth that is entailed by increased welfare expenditures, so that over time the country is seen to be enjoying far higher level of living standards compared to other countries at similar income levels which had been devoting more resources to growth. In other words, the welfarist country becomes an outlier because the short-run trade-off between welfare expenditures and income growth is strongly in favour of the former.

But the outlier status can also emerge from the very opposite fact of the trade-off being adverse for welfare expenditures. Consider countries A, B and C, all of which are initially growing at the same rate, but the first two countries are in a higher league in terms of such indices as the *levels* of per capita income, welfare expenditure, and living standards. At some point in time, B decides to raise its welfare expenditure substantially at the expense of investment and growth, but A and C continue to follow their old growth path. Assume further that while higher welfare expenditures add to the improvement of living standards, the incremental improvement on this account is *slightly less* than the loss of living standards due to slower income growth. In other words, the trade-off between welfare expenditure and growth (in terms of their short-run effect on living standards) is assumed to be adverse for welfare expenditure, but only slightly so.

Now consider the evolving scenario. Over time, as B's income grows more slowly than A's and C's, it will slip into a lower income league, comprising countries such as C. At the same time, since the trade-off has been assumed to be adverse for welfare expenditures, B's living standards will grow more slowly than A's. However, since the trade-off has been assumed to be only *slightly* adverse, B may still remain comfortably above the league of C in terms of living standards. In this way, country B will join the rank of C-type countries in terms of levels of income, but will remain above them in terms of living standards. An Isenman-type cross-country regression will then reveal B to be an 'outlier'.

Notice that the emergence of this outlier status will be 'explained' solely by higher levels of welfare expenditure - there is no 'special feature effect' in this story. And yet, it will be wrong to say that B did a wise thing by opting for welfarism. It follows from our assumptions that if B had persisted in its old course, it would have achieved a higher level of living

standards -- reaching the same level as A's, instead of falling slightly below. Of course, B would no longer be an outlier in that case, for it would then be a typical A-category country. But then there is no intrinsic virtue in being an outlier - what matters is the level of living standards, and that is where B would have lost out by deciding to go 'welfarist'. If this is the story of Sri Lanka, then surely she should look upon her outlier status with more regret than pride!<sup>11</sup>

The essential point is that the mere achievement of an outlier status is no indication of making the most efficient use of scarce resources, even judging by the limited criterion of *immediate* gains in living standards. Such an 'achievement' is consistent with both favourable and unfavourable trade-off for welfare expenditure vis-a-vis growth, and only in the first case can one speak of a genuine achievement.<sup>12</sup> So an assessment of the nature of trade-off is essential for deciding whether Sri Lanka's 'outlier' status is to be interpreted as an advertisement for or an warning against welfarist policies.

One way of assessing the trade-off is to ask the following counterfactual question: if the resources absorbed by welfare expenditures were utilized as investment for growth, how long it would have taken Sri Lanka to reach the standard of living it enjoys today? Sen (1981) posed this question and came up with the answer that it would have taken a very long time. This seemed to suggest that the trade-off was strongly favourable for the welfarist path.

But in retrospect it is not clear that Sen's counterfactual analysis warrants such a conclusion. Consider the technique employed for the counterfactual analysis. First, it was noted from Isenman's cross-country regression for 1975 that a 'typical' country required an annual per capita income of US \$2684 to reach life expectancy of 69 years which Sri Lanka had reached at the per capita income of only US \$130. Then the question was

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<sup>11</sup> Critics such as Bhalla and Glewwe probably have such a story in mind when they point out that starting from about the same position at around 1960, 'growth-oriented' countries such as South Korea have marched ahead of Sri Lanka and now belong to a higher league in terms of both income and living standards, while Sri Lanka takes pride in being an outlier in comparison with countries that were in an altogether lower league to begin with.

<sup>12</sup> This point has seldom been recognized in the literature on the evaluation of 'outlier performers'. A notable exception is Drèze and Sen (1989: 198-9).

asked: how long it would have taken Sri Lanka to go from \$130 to \$2684 if it had chosen the growth alternative? To answer this question, some alternative estimates were made of the rates at which Sri Lanka could have grown if its resources were diverted from welfare to investment. Applying these growth rates, it was finally estimated that somewhere between 58 and 152 years would have been required to reach the income level of \$2684. This was the basis of Sen's conclusion that the growth alternative involved a 'long haul' compared to the welfarist path.

The problem with this analysis is that by asking the growth alternative to bridge the gap between \$2684 and \$130, we are asking it to do too much. Note that the point of this exercise is to compare the actual history of Sri Lanka with the counterfactual history in which there would be no welfare expenditures. But in this counterfactual, Sri Lanka's income in 1975 would be higher than \$130 because all the welfare expenditures that were incurred during its actual pre-1975 history would be transformed into investment. So the gap that would need to be bridged after 1975 would be less than what Sen imposes upon the growth alternative. As a matter of fact, it is not implausible that there would be no gap to be bridged at all, i.e. the counterfactual income in 1975 could well be higher than \$2684. In that case, the conclusion would have to be that, had it pursued the growth alternative, Sri Lanka would have reached its actual '1975 living standards' even before 1975, thus completely reversing our judgement of the trade-off.

Essentially, the problem is that in order to estimate the time disadvantage of the growth alternative one must start from the counterfactual income rather than the actual income of the year for which the cross-country regression has been done (in this case, 1975). But this is not easy to do, since in order to find the counterfactual income one must first locate an 'initial year' in which Sri Lanka was for the last time a 'typical' country, and then apply the counterfactual growth rate to the actual per capita income of that year. This can in principle be done, but there will be insurmountable data problems in doing so. In view of the long history of Sri Lanka's social interventions, one will have to go back to the 1930s, if not earlier, in order to find the 'initial' year, but Sri Lanka's national income data simply doesn't go back that far. There is also the problem that if one wanted to be confident about one's choice of the 'initial' year, then it would be necessary to do a cross-country regression for that year too, so as to ascertain whether Sri

Lanka was indeed a typical country at that time; but it would be impossible to get comparable international data for that period.

The initial year problem also bedevils an alternative methodology developed by Drèze and Sen (1989: 200-1). There, instead of calculating the 'extra time' required by the growth alternative, one estimates the 'extra growth' that would be needed by the outlier country to reach the same living standards it has reached, had it not followed the welfarist path. If this 'required' extra growth appears to be far higher than what could plausibly have been achieved by sacrificing welfare expenditures, then one can conclude that the trade-off has been favourable for the welfarist path.

This is a superior methodology insofar as it does not require the estimation of counterfactual income. If the actual income of the outlier in the year of cross-country regression is  $y$  and that of a typical country in the same year is  $y^*$ , then the required extra growth is given simply by  $(\ln y^* - \ln y)/T$ , where  $T$  is the number of years over which the extra growth would have to accrue. However, the 'initial year' problem still has to be faced. It comes up while choosing the value of  $T$ , since the 'extra growth' must be allowed to accrue from the initial year when the outlier country first chose to embark on the welfarist path.<sup>13</sup> The choice of the initial year can however be quite hazardous, especially in the case of Sri Lanka, for which the pursuit of welfare policies dates back fairly long into history.

It is clear that one needs to employ an alternative methodology whose data requirements are less demanding. As it happens, Anand and Kanbur (1991) have recently done just that. They have carried out a time series regression of Sri Lanka's living standards over the 1960-1978 period, using per capita income ( $Y$ ) and welfare expenditures ( $W$ ) as the explanatory

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<sup>13</sup> In the actual application of this methodology, however, Drèze and Sen seemed to disregard this requirement of counting  $T$  from the initial year. They took China as the outlier case, used the data for the year 1985 for the cross-country regression, and counted  $T$  from 1960. But since they recognize that "China already had an outstanding history of public support" by 1960 (Drèze and Sen 1989: 201),  $T$  should in fact have been counted from an earlier year. In consequence, they overestimate the 'required extra growth'. However, since in China's case the initial year would not in any case go beyond 1950, i.e., since the value of  $T$  would be at most 35 instead of 25 as assumed by Drèze and Sen, the resulting overestimation is not very serious. After appropriate scaling down, the required 'extra growth' still appears large enough to sustain their conclusion that China could not possibly have achieved its outstanding living standards without its welfarist policies (or the strategy of support-led security, as they call it).

variables. The coefficients of these variables give us an idea about the nature of the trade-off. They show, for instance, that one rupee of health expenditure can reduce infant mortality to the same extent as can income growth of Rs 33. Assuming (generously) a marginal capital-output ratio of 3:1, the above figures imply that a rupee spent on health expenditures can achieve 25 times more to reduce infant mortality than a rupee spent on investment and growth.<sup>14</sup> These estimates confirm that the trade-off has been especially favourable for the welfarist path in Sri Lanka.<sup>15</sup> In other words, Sri Lanka could not have improved the living standards of its people faster than it has by diverting resources away from welfare expenditure into investment and growth.

## V. THE LONG-RUN TRADE-OFF ARGUMENT

We have established two propositions so far. First, it is the history of welfare expenditures rather than some fortuitous circumstances that accounts for Sri Lanka's outlier status in terms of living standards; and secondly, while in principle the outlier status is consistent with either a favourable or an unfavourable short-run trade-off for welfarism vis-a-vis income growth, in practice Sri Lanka's outlier status reflects a favourable trade-off. The second of these features conveys the important message that a poor country can vastly improve its people's basic capabilities fairly quickly by pursuing the welfarist path; to achieve the same results through income growth would take much longer. This immediacy in the impact on living standards is indeed the great virtue of welfarist policies, as exemplified by the experience of Sri Lanka.

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<sup>14</sup> Anand and Kanbur's explicit motivation for doing this time-series exercise was to get around Bhalla's objection that the Isenman-type cross-country regression at a point in time leads to misleading conclusions owing to the presence of the country-specific effect, or the special feature effect as we have called it. But, as we have seen, Bhalla's objection does not hold in any case. So the value of Anand-Kanbur's contribution lies not so much in getting around Bhalla's objection to Isenman's cross-country regression, as in offering a more convincing alternative to Sen's counterfactual analysis for ascertaining the trade-off between welfarist and growth-oriented paths.

<sup>15</sup> Anand and Ravallion (1993) have improved upon these estimates by allowing for lagged effects of the explanatory variables. Their estimates indicate slightly less relative advantage for welfare expenditure, but the trade-off still remains overwhelmingly in its favour.

But the quest for immediacy can be carried too far. While the short-run gains may be higher, it is quite conceivable that the long-run consequences may still be adverse. It is a familiar theme of the optimal growth literature that a country that decides to enjoy higher utility in the short run by consuming more of its resources, compared to another country that has decided to save and invest more, may turn out to be following an intertemporally inferior path, judging by the value of the discounted sum of utilities over the entire time horizon. The same argument applies to living standards defined in a broad sense. What matters for a society is not simply the living standards here and now, but the present value of the 'flow' of living standards over successive generations. Therefore, if future realization of high living standards is impeded by the enthusiasm for immediate gains, the outcome may well turn out to be intertemporally inoptimal.

This is of course a very general point, serving merely to emphasize the truism that no action bearing on the future can afford to ignore intertemporal trade-offs. And this is true as much of growthmanship as of welfarism; both can be intertemporally inoptimal if carried to the extreme. Just as welfarism can be inoptimal by sacrificing the welfare of future generations too much, so can growth be inoptimal by sacrificing the welfare of the present generation too much. On purely *a priori* grounds, therefore, neither strategy has any superiority over the other in respect of intertemporal trade-offs. The really important issue is an empirical one: e.g., does the kind of welfarism pursued by Sri Lanka represent an extreme form of welfarism? Has she carried her welfarist credo too far, and damaged the long-term growth prospects so much that continuation of the same policy will condemn it to an intertemporally inoptimal 'flow' of living standards? This question deserves to be explored, not only for the sake of enlightened policy-making in Sri Lanka but also for the benefit of other countries which might consider emulating Sri Lanka's strategy.

It has indeed been suggested by some that Sri Lanka may have carried its welfarist credo a shade too far. An important episode in Sri Lanka's recent economic history that constitutes a focal point of discussion in this context is the almost complete collapse of the economy that happened in the mid-1970s and the ensuing revival that has been brought about by the radical departure in policy regime since 1977. The detractors of Sri Lanka's achievements point

out that the collapse of the mid-1970s was the price that Sri Lanka inevitably paid by neglecting growth for far too long in the pursuit of quick gains in welfare, and that the subsequent revival is a testimony to what can be achieved by pursuing the growth alternative. We shall argue, however, that despite appearance to the contrary, the episode of the 1970s does not warrant a verdict of guilty upon Sri Lanka's welfarist past.

### *The Growth Debacle of the 1970s*

The decade of the 1970s opened with electoral victory for an alliance of political parties belonging to the left of the political spectrum. During the election campaign, this alliance had successfully agitated against the previous government's (rather half-hearted) attempt to reduce the amount of food subsidy -- one of the central pillars of Sri Lanka's welfare state. On the assumption of power, the United Front government formed by this alliance went immediately about restoring the lost subsidies, but soon found itself in deep trouble.<sup>16</sup>

The growth of the economy was slowing down; the annual rate of GDP growth had reached the low of 2.7 per in the 1973-75 period as against 4.8 per cent during 1965-69. Slower growth made it increasingly difficult to sustain high levels of welfare expenditures. Already by 1971, well before the economy was to reach its nadir in the mid-70s, the United Front government felt compelled to retract some of the steps taken earlier to raise the volume of subsidies. This retraction turned quickly into wholesale retreat as the crisis deepened, the *coup de grace* being delivered by the acute balance of payments crisis that developed after 1974. The current account deficit rose from one per cent of GDP in 1973 to four per cent in 1974; and since the subsidized food rationing system depended almost entirely on imported rice and wheat, accounting for a sizeable portion of the import bill (about a quarter in 1970-72), it became impossible to maintain an unreformed rationing system.

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<sup>16</sup> The ensuing economic crisis has been perceptively analysed by Kappagoda and Paine (1981) and Athukorala and Jayasuriya (1991).



A desperate government rang the alarm bell, and slashed expenditures all around. The axe fell not just on food subsidies, but also on health, education and a whole array of public utilities. The percentage share of GDP devoted to social welfare fell from 11.5 per cent in 1970-72 to an average of just 9 per cent in the following five years. The decline in absolute terms was even more striking. The physical amount of subsidized ration of rice was brought down from the peak of four pounds (per person per week) in 1970 to just one pound in 1974; in the four years since 1974, per capita real expenditure on education was on the average 23 per cent lower than in the preceding four years, and that on health was 16 per cent lower.

This massive retrenchment of welfare expenditures was brought about by a regime which had no ideological predilection against a welfare state. On the contrary, the smaller left-wing members of the ruling alliance were the ones who in the past had fought the hardest -- with considerable success - to resist even the slightest deviation from the welfarist path. This time, though, they could only be a grudging accomplice to scaling down the very same welfare state which they had themselves helped to build through nearly half a century of agitational politics.

Welfarism thus emerged as a political orphan through the crisis of the 1970s. As a result, it fell easy prey to the reformist zeal that swept through the corridors of power when the right-of-the-centre UNP (United National Party) formed the government in 1977 with an unprecedented electoral support. By 1985, the share of welfare expenditures had come down to just 3 per cent of GDP from around 8 per cent in 1977, which was already a significant climbdown from the dizzy heights of 12.4 per cent in 1970. At the same time, the growth of GDP surged to a record 6.0 per cent per annum in the 1978-83 period -- an impressive performance compared to the depth of 2.9 per cent in the critical 1970-77 period.<sup>17</sup>

On the face of it, this remarkable episode seems to bear out the worst fears of the critics -- that the emphasis on welfare policies is self-defeating for a poor country in the long run, because by sapping the vitality of the economy it eventually makes the welfare expenditures unsustainable. But in

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<sup>17</sup> Since then both growth has faltered, and the need for at least a modest revival of the welfare state has become politically expedient - but that is a different story.

order to judge if this is really the lesson of the 70s' crisis, we shall have to look more closely at the nature of the crisis and its historical roots.

That there was a serious crisis in the 1970s is undeniable; and that it was the slow growth of the economy that made welfarism unsustainable at the old level is also beyond dispute. But from this it does not necessarily follow that Sri Lanka's welfarism proved to be self-defeating in the long run. For such a conclusion to follow, it will have to be shown that it was welfarism that was responsible for the growth debacle of the 1970s. One must then ask: what are the causal mechanisms through which welfarism is supposed to have led to the growth debacle?

The various mechanisms that have been suggested by the critics can be organized in the standard framework of the two-gap model. Some have emphasized the savings constraint to growth and argued that welfarism led to the growth crisis by reducing the rate of savings and investment. Others have emphasized the foreign exchange constraint and argued that welfarism brought about the growth debacle by precipitating a severe foreign exchange crisis. There are also a number of different stories about precisely how the welfarist policies are supposed to have caused the foreign exchange crisis. As we shall see, however, none of these lines of arguments is good enough to establish the culpability of welfarism for Sri Lanka's growth debacle.

### *The Savings Constraint*

It is a commonplace to suggest that Sri Lanka virtually invited the growth crisis to its door-steps by spending too much on welfare, leaving too little for savings and investment.<sup>18</sup> There is however one fundamental difficulty in taking this route towards blaming welfarism for the growth debacle of Sri Lanka: it cannot be established that in pursuing the welfarist path Sri Lanka neglected savings and investment relative to other countries at comparable income levels. For instance, its savings rate of 12 per cent of

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<sup>18</sup> As one Sri Lankan commentator put it, "Before 1977, the very high level of expenditure on social welfare has been the major factor that has contributed to progressively limit the amount of resources that government could divert to maintain investment at high level." (Karanatilake, 1987: 190-1)

GDP in 1961 was comparable to the average of 11 per cent for the 'low income' developing countries. For the whole of the 1960s, when the ratio of welfare expenditures to GDP was the highest for any decade in Sri Lanka's history, the average savings ratio was 11.5 per cent compared to 14.5 per cent in neighbouring India and 7.0 per cent in Bangladesh. None of this suggests any significant sacrifice of savings on the part of Sri Lanka relative to other comparable countries.

Of course, there was a still sacrifice involved in the sense that the resources devoted to welfare could have been diverted to investment. But since Sri Lanka nonetheless saved and invested at the 'typical' level, such sacrifice cannot by itself explain why Sri Lanka should have been more vulnerable to growth crisis than the 'typical' countries. Only 'excessive' sacrifice of savings -- defined as lower than the 'typical' rate of savings -- could have been held responsible. But clearly no such 'excessive' sacrifice occurred.

But this raises a question: if not savings, then what was actually sacrificed (relative to other countries) which enabled Sri Lanka to finance its above-average level of welfare expenditures? A major part of the answer lies in the expenditure on defense. Until the end of the 1970s, Sri Lanka spent only about 1 to 2 per cent of GNP on defense. For a comparative perspective, one may note that in 1960 the developing countries as a whole spent 4.2 per cent of their GNP to military expenditures as against Sri Lanka's one per cent (UNDP 1991: Table 19). This shows that if there was a trade-off in Sri Lanka, it was between welfare expenditure and defense, and not between welfare and savings.

This is also confirmed by the changes that have occurred after the new regime of the post-1977 period began whittling down the welfare state. Between 1977 and 1985, the share of welfare expenditures in total GDP came down from 8.1 to just 3.1 per cent; and at the same time the share of military expenditure went up from 1.5 per cent to about 5.5 per cent. Once again the trade-off was between welfare and defense. The resources saved by cutting down welfare expenditures (mainly food subsidies) was diverted to defense, not savings. In fact, the domestic savings rate for the 1978-85 period (13.6 per cent) was almost identical to the average rate for the preceding crisis years of 1970-77 (13.4 per cent). The fact that the rate of investment

nevertheless doubled during 1978-85 compared with 1970-77, and so did the growth rate of national income, was due almost entirely to a vastly increased flow of foreign resources, not to the availability of extra resources released by the slashing down of welfare expenditures.

Thus, both the pre-crisis and post-crisis history of Sri Lanka suggest, in their different ways, that welfarism had no trade-off with savings and growth. The pre-crisis history tells us that the savings rate was 'typical' in Sri Lanka despite untypically high welfare expenditures; and the post-crisis history shows that the curtailment of welfare expenditures has not resulted in any increase in the savings rate. By contrast, both before and after the crisis, one observes a clear trade-off between welfarism and military expenditures. Therefore, there is no factual basis for blaming Sri Lanka's growth debacle of the 1970s on the sacrifice of savings allegedly entailed by 'excessive' welfare expenditures.

### *The Foreign Exchange Constraint*

The alternative route to blaming welfarism for Sri Lanka's growth crisis is via the foreign exchange constraint. The argument is based on two propositions: (1) the crisis of the 70s owed itself to a binding foreign exchange constraint, and (2) this constraint was precipitated by the legacy of Sri Lanka's welfarist past.

There is not much doubt about the first of the two propositions. Even without going into sophisticated model-building for identifying the binding constraint, one can see that the foreign exchange constraint rather than savings must have been the major source of trouble. For one thing, the domestic savings rate actually rose to an average of 15 per cent in the first four years of the 1970s from the average of 11 per cent of the preceding five years, before the crunch came in 1974 and 1975. In these two most critical years, the savings rate did of course fall drastically - to about 8 per cent. But this should be seen more as a response to the crisis than a cause of it, in the sense that the savings rate was lowered during these years to protect consumption from bearing the full brunt of the crisis (Athukorala and Jayasuriya, 1991: 115).

The crisis itself was caused, however, by the critical shortage of foreign exchange that had developed over a number of years. The current account deficit in the balance of payments rose from 1 per cent of GDP in 1970 to 4 per cent in 1974. And to make things worse, this happened against a backdrop of increasing difficulty Sri Lanka was facing in financing the deficit. The financing problem arose from two distinct sources. First, already by 1970 the country had run down its foreign asset reserves, thanks to the import boom following the mini-liberalization of 1968; and secondly, loans from the World Bank were not forthcoming because of its insistence on cuts in consumer subsidies as a loan conditionality which the new left-wing government was unwilling to countenance in the early years.<sup>19</sup>

Under the circumstances, the government had no alternative but to resort to severe import compression. But this was not easy to do, because there was no easily compressible 'import fat'. One of the most remarkable changes that had occurred in Sri Lankan economy in the preceding two decades was in the structure of imports. The share of non-essential consumer goods had declined from 20 per cent of total import expenditure in the 1950s to less than 5 per cent by the early 1970s. By contrast, the share of intermediate and investment goods (the so-called 'developmental' imports) had risen from 28 per cent in 1950-51 to 52 per cent in 1970-72. The balance consisted mostly of essential food imports, which served as the life-line of the subsidised food rationing system. There was thus hardly any room for a relatively painless compression of imports.

As we have already noted, the government nevertheless responded by severely restricting the amount of food ration; but it was impossible to impose the full burden of adjustment on the food sector without inviting disastrous social and political consequences. Inevitably, the so-called developmental imports, which accounted for more than half of the import

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<sup>19</sup> There was also an obvious political dimension to the problem of external finance. The western donors were no more eager to bail out a government that indulged in sharp left-wing rhetorics (even though it was generally no more than rhetorics) than the government was willing to go around with a begging bowl, especially under the influence of the genuinely left-wing minor partners of the coalition government. Kappagoda and Paine (1981) provide an illuminating discussion of the government's difficulties with external donors during this period. For a more wide-ranging analysis of the relationship between Sri Lanka and the international donor agencies (especially the World Bank and the IMF), see Lakshman (1985).

bill, had to endure its share of the burden<sup>20</sup>, with the predictable consequence of an all-round slowing down of growth.

So it is quite evident that the growth crisis of the 1970s was induced by a serious foreign exchange constraint. But how can welfare expenditures be held accountable for all this? There are at least two theories: one finds the linkage through the plantation economy, the other through the failure of import substituting industrialization.

*(1) Welfarism and the Crisis of the Plantation Economy:*

The story in which the plantation economy provides the linkage between welfarism and the foreign exchange crisis runs as follows.<sup>21</sup> When the government of the newly independent Sri Lanka strengthened the welfare state in the early 1950s, it decided to finance the increased expenditures by taxing its export crops, namely, tea and rubber. Higher export taxes acted, however, as a serious disincentive to improving the productivity of the plantation sector, thus reducing over time its ability to earn foreign exchange. As a result, the very foundation of the welfare state, which was built upon the plantation wealth, was undermined over time. The cumulative effect of all this became too much to bear in the 1970s when the oil price hike struck and the Sri Lankan economy was unable to counter its effect by expanding its own exports because the vitality of the export sector had already been sapped by the heavy tax burden historically imposed upon it for the sake of financing overblown welfare expenditures. Thus, it was the very mechanism of financing the welfare state that made such financing unsustainable in the long run. In short, this is the old story of killing the goose that laid the golden egg.

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<sup>20</sup> From 1973 to 1974, the import of intermediate goods fell by 47 per cent, capital goods by 52 per cent, and consumer goods by 37 per cent. Over the 1973-75 period, the volume of all imports remained 41 per cent below the 1970-72 level, which itself was 40 per cent below the level of the preceding decade.

<sup>21</sup> This story is told in great details in Bhalla (1988c).

A fine story, except that it has a number of rather serious flaws. In order to see what these flaws are, it will be useful to break down the long story into its component parts. There are actually three distinct steps involved in the argument: (i) first, it attributes higher taxation of exports to the need for welfare financing; (ii) secondly, it holds higher taxes primarily responsible for the slow growth of the plantation economy; and (iii) finally, it blames mainly the slow growth of the plantation sector for the foreign exchange crisis of the 1970s. The problem is that none of these steps can withstand the weight of evidence.

On the link between welfare financing and higher taxation of export crops, the main problem is that since export revenues were used to finance much else besides welfare expenditures, it is not clear why the latter alone should be singled out as being responsible for higher taxes. Soon after Independence, a conscious decision was taken by the state to make sure that the enormous wealth of the plantation sector be harnessed for the benefit of the country as a whole instead of being enjoyed by a small coterie of shareholders as in the colonial past. Higher export taxes were used as the primary means of this intended redistribution. The resulting increase in government revenue certainly allowed higher levels of welfare expenditure, but it also allowed higher levels of all other kinds of expenditure.

Critics such as Bhalla (1988) single out food subsidies as being primarily responsible for higher export taxes, but the fact is that the incremental food subsidies over the 1950s accounted for only just over half (55 per cent) of the incremental export duties collected during this period.<sup>22</sup> Besides, not just export duties, but also import duties and direct taxes increased significantly over this period. Why should it be supposed that all these other sources of revenue financed 'other' expenditures, leaving only food subsidies to be financed by export taxes? Why not the other way round?

Bhalla's answer to this question is simple: because that is how the politicians themselves seem to have perceived it. In support of this contention, he cites a statement made by the Finance Minister J. R.

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<sup>22</sup> This can be seen from the figures for export duties given in Snodgrass (1966, Table 7-3) and for food subsidies given in Rasaputra (1986, Table 22), and by comparing the three-year average of 1948-50 with that of 1958-60.

Jayewardene in 1951, in which he explicitly linked the increased cost of rice subsidy with export taxes:

"These increases in expenditure raised substantially the expenditure estimates contained in my original 1950-51 Budget, so that an increase in revenue became necessary. Accordingly, export duties on the principal export commodities were raised with effect from March 14th." (J. R. Jayewardene, as cited in Bhalla, 1988: 52.)

But the trouble is that one can easily go astray by taking a politician's words for what he has in mind! It made perfectly good sense for a vote-seeking politician to suggest that millions of ordinary consumers were being helped at the expense of a few rich plantation owners (many of whom were also foreigners). But there is no meaningful sense in which one can say that higher export taxes were rendered *necessary* by the decision to raise food subsidies. For, after all, the Finance Minister did have the option of trimming expenditures elsewhere or tapping alternative sources of revenue, thus shifting the cost of subsidies onto some other interest group. If he did not do so, it was perhaps because the political cost of alienating those other groups was perceived to be higher than that of milching the planters. But in that case one can reasonably argue that it was the desire to keep those other interests in good humour, rather than the need to finance food subsidies *per se*, that made it necessary to raise export taxes!

In an attempt to add 'substance' to his claim, Bhalla also carried out an econometric test. He regressed the net producer price of export crops on a number of variables including one designed to capture the pressure of food subsidies. The coefficient of this variable was found to be large and significantly negative for tea (and coconut, but not for rubber). From this he concluded that the pressure of subsidies must have depressed net producer prices by leading to higher taxes. But this does not resolve anything. The problem of course is that any of the other items of budgetary expenditure that were positively correlated with food subsidies would have produced the same result! So, beyond confirming one's prior prejudices, regressions of this sort cannot resolve the question of how to assign the responsibility for higher export taxes. The fundamental problem is that of fungibility. When more than one item of expenditure is financed by resources collected from more



than one source, there is no meaningful way of associating a particular item of expenditure with a particular source of revenue.

The second step in the chain of argument is no less tenuous. Even if one were to assume that food subsidies did in some measure contribute to higher export taxes, one cannot readily relate higher taxes to the poor growth of the plantation sector. This is because there were other strong disincentives at work. The most important of them was the rapid decline in the external terms of trade. By the time the crisis of growth began to unfold in the early 1970s, the terms of trade index had already fallen from 201 in 1955 to 106 in 1970, and then it fell further to 58 by 1975. On top of this, there was a constant threat of nationalization of the estates.

How significant was the export tax in relation to these other disincentives? No one has made a proper quantitative assessment of this matter, which will have to involve comparison of rates of return to capital with and without export taxes. However, Snodgrass (1966: 114-7) did try to form a rough judgement about it by estimating the after-tax profit margins for the period between 1946 and 1960. He noted that despite substantial reduction in profit margins,

"As nearly as any one can tell, all three crops remained highly profitable throughout the post-war era, and had the government not intervened the very same high dividend rates as had been paid out in prewar times ... could probably have been paid out to domestic and foreign shareholders during this period as well." (Snodgrass, 1966: 115-6.)

In other words, at least up to 1960, the redistribution of plantation wealth was achieved by cutting into the 'super profit' of the owners rather than by rendering their business unprofitable.<sup>23</sup> It is of course true that since 1960, profit margins have fallen further, and quite sharply so. But until the late 1970s this was almost entirely due to declining border prices, for neither the export duty nor the cost of production registered an increase during this period (Athukorala and Jayasuriya, 1991: Table SA-19). It is thus far from

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<sup>23</sup> It was in fact a conscious policy of the government to vary the export taxes from time to time in keeping with world prices and domestic cost of production so as to leave the export producer with a constant profit margin per unit exported, thus allowing the producer to gain by expanding the volume of export. For more on this, see Snodgrass (1966, Chapter 5).

clear that export duties contributed in any major way towards reducing the incentive for plantation owners, prior to the crisis of the 1970s.<sup>24</sup>

Turning now to the final step of the argument, it is found to be no less far-fetched than the other two. Whatever may have caused the slow growth of the plantation sector, it is wrong to blame its weakness for the crisis of the '70s. Careful analyses of the crisis have shown that the major part of the problem was of exogenous origin, emanating in part from a precipitous terms of trade decline, and in part from supply shocks in domestic agriculture.<sup>25</sup> As mentioned before, the terms of trade had been declining even before the crisis began -- the index had already fallen from 201 in 1955 to 106 in 1970. Then during the build-up to the crisis -- and even before the oil price shock of 1973 - there was a further decline of 23 per cent over the 1970-72 period. Then came the oil price shock, and the terms of trade declined further. Over the five year period from 1970 to 1975, the total decline amounted to as much as 50 per cent.

At the same time, domestic agriculture came to be crippled by a succession of bad harvests, which aggravated the balance of payments problem from both import and export sides. On the import side, the major problem came from the paddy sector. Abnormally low harvest of paddy for consecutive years from 1970 to 1973 called for increasing import of rice and wheat at a time when the price of cereals was sky-rocketing in the international market.<sup>26</sup> The result was that by 1974 the additional import bill on account of cereals came to exceed the additional cost of importing oil! On the export front, the main disaster came in 1973 when a severe pest attack

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<sup>24</sup> Furthermore, price incentives do not seem to have been terribly effective in Sri Lanka anyway. According to a recent econometric study of the supply response of tea, the long-run price elasticity of output is only about 0.1 in Sri Lanka, as compared with 0.4 for India and Tanzania, and 1.0-1.3 for Malawi and Kenya (Ramanujam, 1986). Obviously, the malady of Sri Lanka's plantation sector is of a serious structural nature that blunts the edge of the price mechanism.

<sup>25</sup> For detailed analyses, see Kappagoda and Paine (1981), Jayatissa (1982), and Athukorala and Jayasuriya (1991).

<sup>26</sup> The poor crop of 1970 was due largely to a mass uprising by the rural youth causing widespread disruption in agriculture and related activities, and that of the following years was due mainly to bad weather. After a brief recovery in 1974, bad weather struck again in 1975, and it was not until the late '70s that paddy production was to recover to its late '60s level.

reduced by one-third the production of coconut -- the third most important export crop (after tea and rubber). In the following year, the production and export of tea also fell, due partly to the disruptions caused by land reforms, and partly to increased cost of fertilizer following the oil price hike.

It can thus be seen that although reduced export of plantation crops did contribute somewhat to the foreign exchange crisis, the reason for this reduction lay more in unforeseen supply shocks than in diminished production due to any lack of price incentives. What is more important, the volume of exports was not the most important problem of the period anyway. It has been estimated, for example, that out of the total loss of export earnings, the division between the loss due to terms of trade decline and the loss due to reduced volume of trade was in the ratio of 83:17 in 1974 and 87:13 in 1975 -- the two most critical years (Jayatissa, 1982). In view of these facts, it cannot but seem far-fetched to blame the slow growth of the plantation sector for precipitating, or even seriously aggravating, the crisis of the '70s. *A fortiori*, to blame welfare expenditures for contributing to the crisis -- at one remove, by slowing down the growth of plantation crops -- must seem exceedingly far-fetched.

## (2) *Welfarism and the Crisis of Import Substitution*

The second theory linking welfarism with the crisis of the 70s makes no such mistake about the nature and origin of the crisis. It fully recognizes that the foreign exchange crisis had its origin in exogenous factors. Welfarism is blamed not for causing the foreign exchange crisis itself, but for aggravating the growth crisis that resulted from the shortage of foreign exchange.

We have noted earlier that the effect of the foreign exchange crunch was as severe as it was mainly because there was no compressible import slack to permit a relatively painless adjustment. So the rigidity of the import structure can be seen to be the 'proximate' cause of the *severity* of the growth crisis. But according to the theory we are going to discuss, the 'ultimate' cause is welfarism, because it is welfarism that is supposed to have led to the rigidity of the import structure. The way it allegedly did so was by making

inevitable a course of import substituting industrialization which in turn led to a rigid import structure. The story thus involves a long chain of argument consisting of several steps.

(a) Excessive welfare expenditures of the 1950s gave rise to soaring budget deficits, which in turn led to worsening balance of payments.

(b) When the balance of payments deteriorated further in the late 1950s as a result of declining terms of trade, the government found it difficult to make the necessary adjustment on the expenditure side, because it was locked into an inviolable political commitment towards welfare policies.

(c) Being unable to adjust expenditures and absorption, the government was forced to adopt draconian measures of import control in the early sixties, forcing the economy willy nilly on to the path of import substituting industrialization.

(d) The inefficiencies and rigidities of import substituting industrialization gave rise to the inflexible import structure which eventually caused so much pain when the foreign exchange crisis struck in the mid-1970s.<sup>27</sup>

We shall not examine all the steps here; for our present purpose it is enough to scrutinize the first two -- i.e. to ascertain if there is any linkage between welfare expenditures and the onset of import controls in the early sixties. Since we are going to argue that this linkage is rather weak, if not non-existent, we shall be able to reject the story as a whole, without taking a position on the last two steps.

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<sup>27</sup> This is our own interpretation of the argument presented in Athukorala and Jayasuriya (1991). It must be noted however that there seems to exist a certain ambivalence in the attitude of these authors towards the culpability of welfare policies. In the early part of the essay (pp. 14-18), they clearly implicate welfare expenditures for forcing the import controls of the early sixties, and hold these controls - and the resulting import substituting industrialization - responsible for increasing the economy's vulnerability to external shocks (chapter 4), thus completing the chain of reasoning we have presented above. But subsequently they declare that welfare expenditure is not the 'key issue', since budget deficit could be taken care of by eliminating other, less efficient, expenditures (pp.174-175). In view of this ambivalence, we propose to examine their argument merely as a possible link between welfare policies and long-term growth, without necessarily suggesting that they actually believe in this link.

The first step of the argument draws upon the logic of the Pollak model (or, the latter-day IMF model) of the balance of payments, in which deterioration in balance of payments is directly attributed to budget deficits. According to this theory, larger budget deficit raises aggregate demand which then spills over into increased demand for imports, and if exports are not rising at the same rate, then the balance of payments must come under pressure in the short run. The Central Bank of Sri Lanka was constantly harping on this theme in the second half of the fifties, i.e., the period building up to the imposition of import control in the early 1960s.

The Bank actually had pretty good reasons to do so. In the first half of the fifties, the budget deficit had moved about erratically depending mostly on the fortune of export crops, which were the major source of government revenue. But the end of the tea price boom of the mid-1950s marked the beginning of a rising trend in budget deficit. Revenues increased very little because the export crops had entered a period of stagnation in terms of both price and volume of exports. At the same time, after fluctuating without any visible trend in the first half of the fifties, budgetary expenditures soared dramatically -- by nearly fifty per cent (in current prices) in the second half of the decade. The mirror image of all this was seen in the deterioration in the balance of payments, as export earnings remained stagnant but imports increased by 35 per cent. Initially, there were enough foreign exchange reserves accumulated from the golden days of the Korean War boom of the early fifties and the tea price boom of the mid-fifties to pay for increased imports. But the reserves soon ran out, forcing the government to impose severe import restrictions.

Thus the story linking budget deficit with the onset of import substitution seems credible enough.<sup>28</sup> But the question still remains as to

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<sup>28</sup> With a major qualification, though. Import restrictions could have been avoided if foreign capital could be mobilized to finance the payments gap. This became politically impossible, however, when, by nationalizing Western oil companies in 1962, Sri Lanka provoked the suspension of American aid, and with it also lost the favour of international donor agencies (Olson, 1977). Later in 1965, when the pro-Western UNP government came to power, the promise of compensation for the nationalized companies opened the way for the resumption of aid, which then allowed the government to sustain much larger volumes of trade deficit than the ones that had forced the preceding government to resort to strict import controls. There was thus much more than the mere economics of the Pollak model behind Sri Lanka's initiation into the regime of import substitution.

how far should welfare expenditures be held responsible for the increased budget deficits? This is where the link becomes weak. It is certainly true that welfare expenditures rose sharply in the second half of the fifties, and it is also remarkable that the incremental budget deficit (Rs 581 million in current prices from 1954/55 to 1960/61) was quite close to the incremental welfare expenditures (Rs 450 million). But that is not the same thing as saying that welfare expenditures accounts for or explains the incremental budget deficit. During the same period, total government expenditure increased by Rs 908 million, which means that welfare expenditures accounted for only half the incremental expenditures. Why isn't the other half blamed for the soaring budget deficit?

The only valid way of picking out welfare expenditures for blame is to start with the prior judgement that, at the margin, such expenditures were less valuable to the society than the 'other half'. Therefore, it is only if one starts with a preconceived notion about their inferiority that the welfare expenditures of the fifties can be blamed for the growth debacle of the seventies. A truly impartial jury must return the verdict of not guilty.

## **VI. COMPLEMENTARITIES BETWEEN GROWTH AND WELFARISM**

We have argued in the preceding section that there is no evidence to support the contention that Sri Lanka's exceptional commitment to welfarism has entailed a conflict with economic growth. In this section, we shall go one step further, and try to make out a case for the somewhat unorthodox view that, rather than providing an example of conflict, Sri Lanka's experience actually provides an excellent lesson in the complementarity between welfarism and growth.

In principle, complementarity can be of different kinds. One kind, which is well-recognized specially in the literature on human capital, is the beneficial effect that well-directed welfare policies can have on the rate of income growth. Welfare expenditures on food, health, and education, not only raise the living standard here and now, but also build up valuable human capital, in the form of healthy and educated people, which can contribute greatly to achieving high rates of income growth.

Complementarity here consists in the fact that welfarism can be supportive of growth.

A second kind of complementarity is based on causality running in the opposite direction, i.e., higher growth being supportive of more vigorous welfarist policies. The point simply is that higher growth can enable a government to mobilize the resources required for maintaining high levels of welfare expenditures. The other side of the coin is that slow growth will eventually make welfarism unsustainable, as it becomes increasingly difficult to find the resources needed to service a growing population.

The first kind of complementarity has not been adequately documented for Sri Lanka, but the evidence for the second kind comes out most vividly from the economic crisis of the 1970s. As we have seen, the critics have looked upon this episode as a prime example of conflict between growth and welfarism, suggesting that it was the excessive preoccupation with welfarist policies that caused the crisis in the first place, which then took its revenge, so to speak, by rendering old-style welfarism impossible to sustain. We have contested the first part of the suggestion, i.e., the part which blames welfarism for the growth crisis; but there can be no denying the second part which holds the crisis responsible for whittling down the welfare state. It is true that in some cases the failure to maintain a high rate of growth may be a consequence of excessive welfarism itself, but this does not seem to have been the case in Sri Lanka.. The crisis of growth had its origin in other sources; but whatever the origin may have been, the consequence was that as the crisis deepened, not even their most ardent supporters could prevent the slashing of welfare expenditures despite holding the reins of political power, simply because there were not enough resources to carry on in the old way. What this episode thus shows is that a poor country cannot afford to sustain an ambitious welfarist policy for a long time, unless it can maintain a commensurate high rate of growth -- this is as stark an illustration of complementarity as one can get.

There is however one other kind of complementarity which is seldom recognized, but which is probably the most important lesson one can draw from Sri Lanka's experience. The second kind of complementarity discussed above focuses on resource constraint: it maintains that growth is necessary for welfarism because otherwise the necessary resources will not be there to

sustain welfare expenditures. But resource constraint is not the only reason why growth is necessary for welfarism; it is also necessary because the combination of poor growth and an ambitious programme of welfarism can have socially harmful consequences! Sri Lanka's problem of youth unemployment -- and its attendant consequences -- is a tragic illustration of this point.

Sri Lanka is rare among countries of comparable income levels in having an exceedingly high level of open unemployment; somewhere between 13 to 15 per cent of the labour force remains openly unemployed even in normal years as compared, for example, with 2-3 per cent unemployment that is observed in other South Asian countries. Apart from the sheer magnitude of unemployment, what is remarkable about this phenomenon is the socio-demographic composition of the unemployed. The vast majority of the unemployed are young people with up to secondary level education, and a disproportionately large part of them are females. For example, the Labour Force Survey of 1985/86 showed the following pattern: more than three-quarters of the unemployed were in the age group of 15-30 years; nearly eighty per cent had education of at least up to the level of grade five; the rate of unemployment rose monotonically with the level of education up to the graduate level; and the number of female unemployed was nearly equal to that of male unemployed although the number of females in the labour force was about half that of males (DCS, 1987a). A broadly similar pattern is revealed by all other labour force surveys (Korale, 1984, 1985, 1986; Bandaranaike, 1987). They also show yet another interesting feature: most of the unemployed spend a considerable amount of time searching for job while relying on their households to support them during the search period.

All this indicates, and the surveys confirm, that households above the poorest groups contribute disproportionately heavily to the pool of unemployed. In other words, while the problems of poverty and unemployment are both massive in Sri Lanka, they are not the same problem. What is it, then, that lies at the root of the unemployment problem? A large part of the answer can be found in the combination of poor growth with highly successful welfare policies.<sup>29</sup> Each of the major constituents of

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<sup>29</sup> Isenman (1980) presents a convincing argument along these lines.



welfare policies -- viz., health, education, and food subsidies -- has played a part.

In the aftermath of the successful malaria campaign of 1946-47 and the subsequent expansion of health facilities at the grass-roots level, infant mortality came down dramatically, but fertility decline did not begin before well into the 1960s. The baby-boom of the intervening period had a lasting impact on the age-structure of the population for the following decades, leading to a disproportionate increase in the young-age population. This resulted in a sharp increase in the proportion of new job-seekers from about the late 1960s onwards.

At the same time, free universal education had shaped the expectations of job-seekers in a manner that was totally incompatible with the structure of opportunities. Those who remained illiterate had no qualms about getting absorbed in any casual work -- even if it meant serious underemployment -- and thus avoided a heavy incidence of open unemployment. But the educated youth was quite unwilling to dirty their hands in petty manual jobs, the only ones that the poor traditional economy of Sri Lanka could afford to offer in any significant amount (Marga, 1977; Gunatilleke, 1988). For example, in a nation-wide survey conducted in 1981/82, only 8 per cent of the unemployed expressed an interest in joining agriculture - the largest absorber of the country's labour force. As much as 37 per cent sought industrial employment, which could only absorb up to a quarter of the employed population at the time. Most strikingly, 44 per cent preferred to enter white-collar occupations as professionals, managers, and clerks; but these professions had the capacity to absorb no more than 10 per cent of the labour force. These scarce white-collar jobs were the particular favourites of females (who had been drawn into the labour force at a much faster rate than ever before, thanks to the provision of free universal education); and that is at least part of the reason why the educated females have come to share a disproportionately large burden of open unemployment.

In view of this mismatch between expectations and opportunities, successive governments have tried special measures to tackle the problem, such as, encouraging mechanization in agriculture in the hope that the educated youth would not find it below their dignity to go to the field once

they know that they will drive a tractor instead of a bullock, or allowing deliberate overmanning in the public sector to fulfil the aspirations for white-collar jobs, etc. But these measures could hardly offer a lasting solution, which could only come from rapid economic growth, bringing with it structural transformations that expanded job opportunities in the industrial and services sectors.

As the mismatch persisted between expectations and opportunities, many of the frustrated job-seekers would normally have drifted away into some form of underemployment over time, thus reducing the incidence of open unemployment. But this did not happen; and at least a part of the reason must lie in the existence of the subsidized food distribution system which allowed the families of the unemployed youth to support them at a minimum subsistence level more or less indefinitely. This is what accounts for the observed phenomenon that a major part of Sri Lanka's open unemployment is of a persistent nature -- people searching for non-existent jobs while drawing upon family resources for survival.

Thus it is that the combination of slow growth on the one hand and welfarist policies in the spheres of health, education and food on the other, has led to the emergence of a large pool of educated unemployed youth. This is a serious problem in itself; but it is also a problem that can be instrumental in creating even more severe problems. Persistently high level of open unemployment among the educated youth is a potential source of social explosion anywhere. And Sri Lanka has been particularly unfortunate in this regard. It is arguable that the bloody uprising that rocked the country in 1971, and the even bloodier ethnic strife that has plagued it ever since the early 1980s, is a fall-out of this phenomenon. This is not to suggest that these incidents had no other origin. The point is simply that in the absence of the explosive potential generated by the presence of a large body of frustrated youth, the underlying discontent behind these incidents may not have exploded in so violent a manner.

It is notable that ethnic discontent is nothing new in Sri Lankan life. In modern times, it has been festering ever since the 1920s when the nationalist politics of the country became polarised along the Tamil-Sinhalese divide. The problem became sharply accentuated in the 1950s when the Sri Lanka Freedom Party was launched by appealing to the raw emotion of Sinhala

nationalism, with a view to exploiting the incipient Sinhalese resentment against the preponderant presence of Tamils in bureaucracy and other areas of social prominence. Since then, the Tamils have found their relative position in the society decline in a continuous manner. There was however no significant structural break in communal relationship in the early years of the 1980s that can account for the gruesome violence that followed. There were, to be sure, some isolated incidents that ignited the passion on both sides, but that this ignition could lead to an exploding cycle of violence was precisely because the country was sitting on a massive time bomb that needed no more than a spark of fire to explode with devastating consequences. This time bomb consisted of none other than the restless energy of the frustrated youth. And, as we have seen, their frustration was to a large extent the outcome of inadequate economic growth combined with highly successful welfare policies. Here is a testimony, written in blood, of the essential complementarity between welfare policies and economic growth.

## VII. SUMMARY AND CONCLUSIONS

We set out to answer the question: what lesson can we learn from Sri Lanka about the wisdom of pursuing a welfarist intervention policy? Such policies are typically justified on the grounds that they would raise the living standards of the people much faster than would otherwise be possible, and that if judiciously chosen they would not entail any significant sacrifice of economic growth either. Does the Sri Lankan experience lend any support to such comforting thoughts?

Several critics have suggested that it does not. The most extreme version of their argument contends that welfare expenditures have had little effect on the living standards of the Sri Lankan people -- if they are nonetheless seen to enjoy exceptionally high living standards, it is because of the presence of some unusually favourable circumstances. In other words, the celebrated 'outlier' status of Sri Lanka is supposed to owe little to her much-trumpeted welfare policies. A less extreme position holds that while the outlier status may well be due to welfare policies, this is not something that Sri Lanka should feel proud of, because opting for higher rate of growth

instead of welfarism would have given her people an even higher standard of living even though it might have robbed her of the outlier status. In other words, while granting that welfare expenditures may have had some beneficial impact, it is contended that the short-run trade off between welfare expenditures and investment was adverse for the former, in the sense that even better results would have been achieved if the resources spent on welfare expenditures had instead been allocated to investment for growth. A final line of argument maintains that, regardless of the nature of the short-run trade-off, the long-run consequences must be considered to have been adverse. This is because welfarism is supposed to have stifled growth in various ways, with the result that in the end welfarism itself was rendered unsustainable as resources could not be found to carry on with the old policies. The empirical support for this line of argument is drawn from the crisis of growth that engulfed Sri Lanka in the 1970s.

We have examined each of these lines of argument, and found them wanting. As regards the first and the most extreme view, we have seen that Sri Lanka's 'outlier' status has to be attributed to her welfare policies, and not to any providential circumstances. This means that welfarism does deserve the credit for raising the living standards of the Sri Lankan people to exceptionally high levels. We have also seen that the short-run trade-off was highly favourable to welfare expenditures vis-a-vis income growth, i.e., the results could not have been improved in the short run by diverting resources away from welfare towards investment for growth.

On the question of long-run consequences, we agree that the growth crisis of the 1970s did render it impossible to maintain old-style welfarism, but we do not accept that welfarism can be blamed for engendering that crisis. Two broad lines of argument have been advanced by the critics by way of implicating welfare policies in the growth debacle. One of them focuses on the savings constraint to growth, and the other on the foreign exchange constraint; welfarism is supposed to have led to the crisis by accentuating one or the other of these constraints. However, the 'savings constraint' argument does not hold, simply because it is quite evident that what Sri Lanka sacrificed in the process of maintaining an exceptionally high level of welfare expenditure was not savings but defense expenditures. The argument based on 'foreign exchange constraint' does not hold either, but the issue is much too involved to be summarised neatly here. The essential point

is that while the foreign exchange constraint did play a critical role in engendering the crisis of the 1970s, there is no sensible way in which Sri Lanka's welfarist history can be implicated in the accentuation of this constraint.

In short, we have argued that (a) Sri Lanka's outstanding achievement of living standards owes primarily to her welfarist policies, and (b) these achievements were accomplished much more rapidly than would be possible if the resources devoted to welfare expenditures were diverted instead to investment for growth, and (c) the pursuit of rapid gains in living standards did not entail a sacrifice of long-term growth prospects, and one of the reasons why it did not do so is that the resources for welfare expenditures were found not at the expense of savings and investment but at the expense of military expenditures.

Thus, the general lesson that one can draw from Sri Lanka's experience is that even a poor country can bring about rapid improvement in the living standards of its people by adopting a judiciously designed welfarist strategy, and further that the pursuit of rapid gains in this manner need not involve a conflict with growth and hence need not entail a loss of welfare in the long term. But there is another dimension of the Sri Lankan experience which offers no less valuable a lesson. It shows how important it is to maintain a satisfactory rate of economic growth for the sake of welfarism itself; if, for whatever reason, growth remains sluggish, it might spell disaster for the welfarist strategy. This is so for at least two reasons. First, sooner or later it would become difficult to find enough resources to maintain the old standard of welfare expenditures, as is testified by the episode of Sri Lanka's economic crisis of the 1970s. Secondly, the combination of poor growth and ambitious welfarism can be a lethal one from the social point of view, as is testified by Sri Lanka's unending troubles emanating from the frustrations of her educated but unemployed youth. What we therefore learn from Sri Lanka about the relationship between growth and welfarism is firstly, that it need not be one of conflict, and secondly that it is more likely to be one of complementarity, in more ways than one.

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