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Economic Growth and Redistributive Justice As Policy Goals: A Study of the Recent Experience of Sri Lanka*

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1. Introductory

Since political independence, governments of different shades of political opinion in Sri Lanka have sought to achieve a number of different policy objectives in their management of the country's economic affairs. In very broad terms, these objectives can be grouped under the following headings: (1) economic growth[1]; (2) redistributive justice or what is more commonly known as "social welfare"[2]; (3) employment creation; and (4) internal and external economic stability[3]. These broad objectives have been sought within an economic structure which could be called "mixed" where: (a) private enterprise, mainly local, but also to some extent, foreign, was given relative freedom of action, (b) the role of the government sector in selected areas became increasingly prominent and (c) resource allocation patterns were determined generally in accordance with the movements in relative price with an increasing role, however, being assigned to direct controls.[4]

The present study examines the inter-relations and interactions between economic growth and redistributive justice as objectives of economic policy, within a mixed economy framework. As a country's resources are scarce and compete for alternative uses, a government may be able to pursue both objectives simultaneously only at the risk of some trade-off, however small it may be. But in order to raise people's living standards and promote social welfare, which is what economic policy is all about, redistributive justice is as necessary as the growth of national output. In Sri Lanka, in particular, redistributive justice had a strong claim to equal priority with other objectives in

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1 Throughout the paper "economic growth" (i.e. a sustained secular increase in real per capita income) is distinguished from the much broader concept of "economic development", which implies, in addition to output expansion, a simultaneous alleviation in the problems of unemployment, inequality and poverty.

2. The term welfare in this sense is really a misnomer. Social welfare, on the whole, depends not only on income redistribution in favour of the poor but also on the growth of total output available for distribution.

3. The above classification should by no means be taken to imply that these objectives are assumed to be mutually exclusive in a rigid sense.

4. No documentation is provided on the matters briefly mentioned in this paragraph. For some documentation based on the experience of the first decade after independence see (Lakshman, 1973, pp. 246a-246k). See also (ILO, 1971, pp. 11-21) where the policy objectives and strategies are, however, classified and discussed in a somewhat different manner.

economic policy on political, social and humanitarian considerations. However, the viability of any redistributive strategy is likely, in the long run, to be seriously undermined by economic stagnation. The higher the rate of growth of output the greater the scope for redistributive action.

The concensus of opinion so far is that, in Sri Lanka, the government's excessive preoccupation with redistributive justice was an important factor within a complex situation which led to a low rate of economic growth. It is clear that the emphasis placed here on the competitive claims, generated by the operation of these two policy goals, on limited resources that were available.

The present study, however, draws attention to certain useful complementarities which existed between the two objectives. It accordingly argues that, within a proper policy mix combining an adequate number of instruments, Sri Lanka could have grown more rapidly in the recent past than it actually did with the same or even a higher commitment to social justice.

It is useful first to briefly outline the contexts in which the current opinions about the relationships between redistributive justice and economic growth have been formed in Sri Lanka. Gross National Product at constant (1959) factor cost grew at the rate of 4.1 per cent per annum between 1959 and 1973, from Rs. 5,893 million to Rs. 10,382 million. As a result of the almost continuous deterioration in the terms of trade, the compound annual rate of growth of Gross National Income at constant factor cost was, however, lower at 3.2 per cent. As the population increased at 2.3 per cent annually the real GNP per capita grew at 1.8 per cent and the real GNI per capita at 0.9 per cent per annum. By international standards, the country's above performance in economic growth is obviously rated as extremly low and disappointing.

Due to Government redistributive measures, however, there has been some reduction in the degree of the society's income inequality. The concentration ratio for income receivers for the country as a whole significantly declined from 0.49 in 1963 to 0.41 in 1973 and that for spending units from 0.45 to 0.35. The proportion of the total income earned by the highest 30 per cent of income receivers dropped from 66.71 per cent to 58.54 per cent while that of the lowest 30 per cent of income receivers slightly increased from 7.45 per cent to 9.35 per cent between the same years. Those who gained most from government redistributive policies appear to have been the middle 40 per cent of income receivers. Their income share went up from 25.86 to 32.11 per cent (Source: Central Bank' 1974, pp. 60-62). Even if some allowance is made for the inherent weaknesses in the underlying survey data, this shows that government redistributive policies in the last decade have succeeded in producing greater equality in income distribution.[5]

Redistributive justice, however, calls for not only greater equality in income distribution, but also lessening of concentration of wealth and

5. Though income shares of the poor sections of the population increased, the degree of their poverty in absolute terms may or may not have improved, depending on the extent of the rise in the cost of living. Or on the basis of some income norm defined in terms of calorie intake and nutritional levels, clothing, sanitation, health education and so on, the low income groups may still be remaining absolutely poor despite the improvement in their relative income shares.

opportunities (ECAFE, 1971). As the inter-temporal changes in the distribution of wealth and opportunities are difficult to gauge adequately for lack of necessary data, there is an understandable pre-occupation with changes in income distribution in the studies dealing with matters concerning social justice.[6] The present study, however, stresses the need to define redistributive justice in its broad sense if the impact of redistributive policies on a country's growth prospects is to be satisfactorily examined.

Setion II of the paper describes the policy framework developed in Sri Lanka to achieve economic growth with redistributive justice. The analysis here is mainly of the policies for the redistribution of income.[7] Section III deals with current views on the relationships between redistributive justice and economic growth. It identifies three main strands in the argument that policies adopted in Sri Lanka for greater income equality were rather inimical to "rapid"[8] economic growth — (a) the savings argument, (b) the balance of payments argument and (c) the incentives argument. Section IV discusses the inadequacies in the strategies adopted in the past to achieve economic growth with social justice. The main theme developed in the paper is that these two objectives could be made quite compatible with one another within a policy mix combining an adequate number of instruments and employing them on the basis of a proper set of selectivity criteria.

The author notes with regret that some of his propositions in the paper are not adequately subtantiated for lack of statistical data. The data problem has been made still worse by the fact that a need for redefinition of certain accepted macro-economic concepts is urged. Some other arguments advanced are, anyway, mere qualitative judgements, the quantification of which by their very nature is almost impossible. Though unverified and inadequately quantified these "heretical" views are worth expressing in the specific contexts of Sri Lanka,[9] at least for purposes of stimulating further discussion and research.

II. Growth cum Redistributive Strategy: An Overview.

During the quarter century after independence, the economic strategies of different governments aimed at both economic growth and social justice. The three years 1953-55 may perhaps be cited as exceptional because a gradual but abortive attempt was made to assign lower priority to social justice as a major objective during that period. Generalisations applicable even for the rest of the post-independence period, however, are rather difficult with respect to the chosen government strategy of economic growth with redistributive justice. With the changes of governments the relative weight assigned to different elements in this broad strategy has also changed. What is attempted below is to trace the salient features of the policy in this connexion without going into details of its changes over time.[10]

6. Though not often seriously thought of, the comparison of patterns of income distribution over time also raises various conceptual and statistical problems (Kuznets, 1965).
7. Any policy of income redistribution will no doubt have some impact on the distribution of opportunities and wealth. The policy of free education in Sri Lanka, for example, has helped to lessen inequalities in the distribution of both incomes and opportunities.
8. What people mean by "rapid" here is never precisely defined, with respect to the time span involved and the numerical annual rate of growth.
9. They are not so heretical though, in the literature on development economics in general.
10. The discussion, moreover, assumes some familiarity with matters concerning economic policy in Sri Lanka.

As a result of the expansion of directly productive activity in the public sector and numerous controls over the activities of the private sector, the government's overall involvement within the economy has significantly widened and deepened in the recent past. The aggregative expenditure patterns, however, still remain dominated by the private sector. As can be seen from Table 1, the public sector as a whole contributes about 20 per cent of Gross Domestic Expenditure and about 40 per cent of the country's Gross Domestic Fixed Capital Formation. The government has been politically constrained to maintain and work within this mixed structure of the economy. The contradictions inherent within such a system arising from the co-existence of a strong private sector and a growing public sector, both claiming for the country's limited resources, naturally imposed certain rather inevitable restrictions on the government in its attempts to promote rapid growth with social justice.

It may appear helpful to maintain a conceptual distinction between the government's growth strategy, on the one hand, and its redistributive strategy on the other. In discussing actual government policies and their socio-economic impact, however, there are practical difficulties in maintaining this distinction, as measures and instruments of government policy carried, more often than not, both growth-stimulating and redistributive effects, whether so intended or otherwise. It is more practicable and meaningful therefore to arrange the discussion according to selected major areas of government activity which influenced the country's rate of economic growth and/or the pattern of its income distribution.

TABLE 1

Composition of Gross Domestic Expenditure at Market Prices: Averages for 1959-60 and 1972-73

		1959-60	1972-73
(A)	GDE at Market Prices (Rs. millions)	6,769	15,345
	Of Which: Per cent.		
	Private Consumption	71	72
	Public Consumption	13	13
	Gross Domestic Fixed Capital Formation	16	15
	Of Which:		
	Public Sector (a)	6	5
	Private Sector	10	10
(B)	GDFCF at Market Prices (Rs. millions)	1,070	2,350
	Of Which: Per cent		
	Public Sector (a)	39	37
	Private Sector	61	63

Note: (a) Includes government, public enterprises and public corporations.
Source: *Central Bank Annual Report*, 1968 and 1973.

II. 1 Private Sector Incentives

Growth strategies are sometimes classified into two broad categories: (1) incentive stimulation (or maximisation) strategies and (2) resource accumulation strategies (Thurow, 1971). The adoption of the former requires the assumption that the private sector is composed of rational, hard-working income maximisers who will act, through the incentives provided, to reach the maximum feasible rate of economic growth. The latter strategy, based on the assumption that the private sector is incapable of mobilising sufficient resources to attain the highest possible rate of growth, makes the government manipulate its tax and expenditure policies to accumulate resources for growth.

Given the mixed structure of the economy, the government strategy for growth promotion in Sri Lanka has incorporated elements of both incentive stimulation and resource accumulation. The private sector has been assigned the major role in the mobilisation and allocation of resources for growth within the bulk of the economy. Although some aspects of government policy, by creating a sense of uncertainty in the minds of the private sector, may be said to have discouraged private enterprise, it is broadly true that the government undertook to produce the favourable climate for vigorous private sector initiative. Heie the government strategy centred mainly on (a) fiscal incentives,[11] (b) producer subsidisation and (c) the provision of infrastructure. Successive governments have placed a heavy reliance on the growth of output in import-substituting agriculture in order to promote overall economic expansion. Given the preponderance of peasant activity in this sector, the government policy to stimulate its growth has taken the form of a plethora of promotional measures such as guaranteed prices, irrigation and land development, input subsidisation and import restrictions. The field of export agriculture too has been predominantly in the hands of the private sector, composed of smallholders as well as big estate companies. The growth strategy with respect to this sector again involved the provision of fiscal incentives and infrastructure and producer subsidisation in varying degrees. For that part of the manufacturing sector demarcated for private sector initiative, price incentives through import controls and high tariffs as well as various tax concessions[12] have been lavishly provided. This incentive stimulation strategy has further been widened recently in order to promote new lines of foreign exchange earnings. Here the main instruments of policy are the dual exchange rate system embodied in the Foreign Exchange Entitlement Certificates (FEEC) scheme and the device of convertible rupee accounts. Tourism and non-traditional export activities among which the gem industry is receiving the most favourable treatment are the main sectors which benefit from these more recent innovations in the incentive stimulation strategy of the government.

The strategy of incentive stimulation has had certain costs for the government budget. On the one hand, government funds had to be spent, for example, on transfers like producer subsidies and for the provision of infrastructure. Its costs, in the other hand, took the form of revenues foregone as a result of various tax concessions. The incentive stimulation strategy thus obviously influenced government revenue expenditure policies.

The government's major intention in its measures to boost up private incentives was, no doubt, to accelerate the growth of output. In the particular context in which such measures were implemented, they also probably contributed to lessen income inequalities. Insofar as agricultural producer subsidisation and quantitative controls on food imports tipped the domestic terms of trade in favour of import-substituting agriculture,[13] a relative improvement in incomes within that sector can be expected. As domestic agriculture has traditionally been a low income sector of the economy, any relative improvement in its income position implies more egalitarian income distribution.

11. Tax holidays, tax exemption of capital expenditure, lump sum depreciation allowances development rebates etc. (for details, see the Department of Inland Revenue, 1972).
12. Some of these tax concessions have been withdrawn in the Budget Speech for 1975.
13. What actually happened to the terms of trade of the domestic agricultural sector in the recent past, however, has yet to be firmly established.

Incentives provided for the output expansion in domestic agriculture and the recent technological progress (green revolution) stimulated by such incentives, however, probably produced greater inequality among the rural peasantry. Though there is no room for precise quantification, it is believed that the benefits of the more recent progress in import substituting agriculture are concentrated within a small minority of prosperous farmers (See e.g. Amarasinghe, 1972).

II. 2 Developmental Expenditures

Economic *development* involves, among other things, the growth of national output and its more equal distribution. All government expenditures with favourable effects on economic growth and redistributive justice can therefore be called developmental expenditures, even if this terminology may not completely agree with accepted usages.

The growth of a country's national product depends, among other things, on the expansion of the volume and the improvement in the quality (or productivity) of its resources—*both* physical and human. Many items of government expenditure contributed to such resource accumulation[14]—some directly and some indirectly through providing for private incentives. Our concentration here is on the former category.

There will be hardly any disagreement about the fact that government capital expenditure on real assets helped resource accumulation within the economy. Certain current expenditures too carried favourable effects on at least human capital formation. Among them, current expenditure on education and health can be identified as perhaps the most significant ones. Current expenditure on economic services also may have contributed to resource accumulation for economic growth.

All these expenditures, including capital expenditure on real assets, in addition to their beneficial impact on resource accumulation, also produced redistributive effects. Given the policy of evenly distributing government and semi-government capital projects over the country as a whole, government capital expenditure led to lessening of regional inequalities. Free education and free health[15] have been major redistributive weapons of the government. Many other resource accumulative expenditures, as they benefited the poor more than the rich strata of the society, also operated as measures in the strategy for redistributive justice.

The relative significance of the resource accumulation impact, on the one hand, the the redistribution impact on the other, of different items of developmental expenditure was obviously not identical. While the incidence on resource accumulation was greater in the case of capital expenditure items, the effects of current expenditure on education and health were probably either equally distributed on resource accumulation and income redistribution or

14. The expression "resource accumulation" is hereafter used to cover both its aspects—the growth of the volume of resources and the improvement in their productivity and efficiency.

15. Although a nominal fee of 25 cents is being charged for medicines and drugs provided in out-patients' departments of hospitals since 1971, consultation and hospital facilities are still free of charge.

distributed more in favour of the latter. No attempt is made here to quantify the relative impact of developmental expenditures on growth and redistribution. We only underline their two-faceted nature.

The objective of rapid growth with social justice produced a need for a rapid expansion of these developmental expenditures. The manner in which the government actually responded to this need during roughly the 1960's can be seen from Table 2 below. Though the Table includes all the major items of government developmental expenditure, it does not claim to be comprehensive and exhaustive. At current prices, all these expenditures, with the exception of the capital expenditure on real assets, increased rather rapidly at 6-7 per cent per annum in the recent past.

A 6 per cent annual rate of growth of government developmental expenditure at current prices probably does tell very little about the extent of its impact on the country's productive capacity and income distribution patterns. On the one hand, as a substantial part of this growth was due to increases in prices and wages,[16] the annual incremental contribution of government developmental

TABLE 2

Selected Developmental Expenditures of the Government: Averages for 1962/3—1963/4 and 1970/1—1971/2 and their Rates of Growth (a)

	1962/3-1963/4	1970/1-1971/2(b)	*Annual Compound Rate of Growth %*
	Averages in Rs. Millions		
1. Capital Expenditure on Acquisitions, Construction and Maintenance of Real Assets	335	490	4.9
2. Current Expenditure on:			
(i) Education	299	502	6.7
(ii) Health	144	246	6.9
(iii) Economic Services	92	148	6.1
3. (i)+(ii)+(iii) above	535	896	6.7
4. 1+2 above	870	1,386	6.0

Notes: (a) Data for financial years before 1962/3 are not available in the same classificational format.

(b) Available data for 1971/2 are for a 15 months period. Expenditure figures for a 12 months period worked out on a pro rata basis have been used in the Table.

Source: *Central Bank Annual Report*, 1971 and 1973.

16. Some relevant indices which are available indicate the following annual rates of price and wage increase:

Indices		*Annual Per cent Increase* 1962-1972
Import Unit Value—Investment Goods	..	10.3
Import Unit Value—Intermediate Goods	..	4.3
Colombo Consumers' Cost of Living	..	3.6
Wages of Government Employees	..	3.1

Source: *Central Bank Annual Report*, 1973.

expenditures to resource accumulation was at a much lower rate than 6 per cent. On the other hand, the distribution of the benefits from these expenditures among different income groups is not definitely known to judge the extent of their redistributional impact. Given the society's low level of economic attainment and incomes, however, one may guess that there was the need for a more rapid expansion of these developmental expenditures.

II. 3 Government Transfers

Government transfers are classified into two categories: current and capital. Data so classified are available from 1962/3 onwards. As Table 3 shows, total capital transfers have grown at a higher annual rate than total current

TABLE 3

Government Current and Capital Transfers: Averages for 1962/3—1963/4 and 1970/1—1971/2 and Their Annual Rates of Growth

	1962/3-1963/4	1970/1-1971/2(a)	*Annual Compound Rates of Growth %*
	Averages in Rs. Millions		
Total Current Transfers	749	1,443	8.5
Of Which:			
Gross Food Subsidy	424	595	4.3
Net Food Subsidy(b)	280	531	8.3
Pensions	108	182	3.7
Total Capital Transfers	117	313	13.1
Of Which:			
To Public Corporations	94	270	14.1

Notes: (a) For 1971/2, 12-months figures on a pro rata basis.

(b) Gross food subsidy minus profits from the sale of certain foodstuffs sold under government monopoly.

Source: *Central Bank Annual Report,* 1971 and 1973.

transfers. While the net food subsidy which accounted for about 37 per cent of total current transfers in the early seventies has grown at about the same rate as total current transfers, capital transfers to public corporations have increased at a slightly higher rate than total capital transfers.

Transfers are normally defined as unproductive unilateral payments "..which are simply means of redistributing, among the different members of the community, the goods and services produced in the economy. ..they are simply transfers of purchasing power and are not the counterpart of any addition to current output of goods and services." (Beckerman, 1969, p. 7). If a payment made during a given period of time does not have a corresponding *quid pro quo* in goods (or services) delivered (or rendered) in the same period, then it is normally considered a transfer—as it does not contribute to *current* output. But a payment, even if it does not appear to yield a corresponding *quid pro quo* in the current period, might enable its recipient to contribute to output more than what his contribution would have been without it, at least in subsequent periods. Such payments may still be called transfers as they are not made in return directly for any identifiable and quantifiable service rendered but they should not be considered unproductive as the prevalent concept of transfer implies. Old age pensions, for example, insofar as their recipients are completely away from the economy's productive activity, may be considered a mere transfer of purchasing power with no contribution to output—current or future.

This is, however, not so in the case of all government transfers in Sri Lanka —not even all current transfers. A fair proportion of the beneficiaries of some current transfers like the notorious food subsidy has been engaged in the economy's productive activity with incomes insufficient for minimum subsistence requirements. Insofar as their level of nutrition was raised by the government transfer there would have been a definite improvement in their capacity to work and consequently their contribution to current or future output would have increased. Accordingly, even a part of the government current transfers should be considered a "developmental" instrument with effects not only on income redistribution but also on overall income growth, whether actually so intended or not. This argument is developed further in Section III.1 below.

Capital transfers, on the other hand, have been mostly intended for resource accumulation within the non-central-government public sector—mainly public corporations and local authorities.

The objective of economic growth with social justice anyway produced a heavy burden on the government budget through rapidly growing "developmental" expenditures and transfers. This in turn produced a need for increasing revenues. A vigorous revenue policy thus came to be an essential ingredient in the government strategy of growth with an equitable income distribution.

II. 4 Revenue Policy

Sri Lanka is a country where government revenue reached high levels relative to GNP at a rather early stage in economic development. By the beginning of the 1960's, total government revenue was as high as 23 per cent of GNP (Table 4). Even in the 1950's its tax effort had been ranked high by international standards (Cf. Adler, 1969, p. 433; ECAFE, 1960, p. 84, Lotz and Morss, 1967). Despite many changes after the 1950's, indirect taxes on production and expenditure continue to form the predominant source of government revenue. The share of income taxes had been a mere 15 per cent in the early seventies. The composition of the revenue from indirect taxation has however, undergone substantial change since the late fifties. As a result of the stagnation of the volume of the three main traditional exports and the continuous drop in their prices on the one hand, and the policy of progressive extension of quantitative restrictions on imports on the other, the share of customs duties fell from slightly less than 50 per cent in the early sixties to less than 20 per cent in the early seventies.[17] With the dwindling importance of traditional revenue sources, the government tapped new sources of indirect taxation in order to meet its revenue requirements. Sales and turnover taxes and the revenue from the sale of FEECs have turned out to be the main sources of revenue in recent years. Despite the utilisation of new revenue sources, the revenue GNP ratio however, has registered only a marginal increase.

The manner in which the government tapped its revenue sources, was, moreover, influenced by the redistribution objective. Progressive income taxation and selective indirect taxation have been major instruments in the government strategy for income redistribution.

17. The fall in the revenue from import duties is somewhat misleading as the revenue from the sale of FEECS to importers since 1968 may rightly be considered somewhat equivalent to import taxation.

TABLE 4

Government Revenue and Its Composition: Selected Items: Averages for 1959/60—1960/1 and 1970/71—1971/2.

		1959/60-1960/1	1970/1-1971/2
(1)	Total Government Revenue (Rs. m.)	1,459	3,048
(2)	(1) as per cent of GNP at Current Factor Cost (a)	23	25
(3)	Composition of (1) above— Selected Items (Per cent)		
	(i) Personal and Corporate Income Taxes	16	15
	(ii) Taxes on Production & Expenditure	63	65
	Of Which: Sales & Turnover (General and Selective) Taxes	8	24
	Import Duties	29	9
	Export Duties	17	8
	FEECs	—	14
	(iii) All taxes and Social Security Contribution	80	82

Note: (a) Government revenue in 1959/60-1960/1 as a proportion of GNP in 1960-61. Available data on government revenue for 1971/2 is for a period of 15 months. Revenue for 12 months has been calculated on a pro rata basis and this added to the revenue for 1970/1 has been related to GNP of 1971-72.

Source: *Central Bank Annual Report*, 1968 and 1973.

During the sixties and the early seventies income tax rates varied from 5 per cent on low levels of taxable income to 85 per cent on very high levels. There has been a rather steep progression in the tax rates with every step upwards in taxable income. In 1959 60, 23.9 per cent of total declared taxable income was subjected to tax rates of 50 per cent and above. The contribution of this group to total income tax revenue amounted to 39.9 per cent. Tax burden on high income groups was gradually raised during the 1960's and as a result, the above proportions have gone up to 41.9 per cent of total declared taxable income and 70.7 per cent of total income tax revenue in the assessment year of 1969 70.[18]

Statistical data on the selectivity of indirect taxation are difficult to come by but the proclaimed policy of different governments has been to tax commodities entering into consumption of high income groups more heavily than articles of mass consumption. Despite these proclamations, indirect taxation may have had regressive effects at times when the tax base was an article of mass consumption like tobacco.

Despite the government's attempts to widen the tax base, the growth of its revenue—about 7 per cent per annum in the sixties—has not been rapid enough relative to requirements, even at current prices. With the gradual increase in the general level of prices, the real purchasing power of government revenue grew even less rapidly. Therefore the government naturally had to keep its developmental expenditures and transfers within limits dictated, not by the real needs of the society, but by the rate of growth of its revenue. As a result mainly of the sluggishness in revenue growth relative to requirements, the twin objectives of growth and social justice led to deficit financing, the net cash deficit rising, on average, from Rs. 440 million in 1959/60-1960/61 to Rs. 1,189 million in 1970/71-1971/72.

18. Source: *Administration Reports of the Commissioner of Inland Revenue*, 1959/60 and 1969/70.

The above discussion draws attention to the fact that the government sought to promote both economic growth and redistributive justice through various fiscal measures. The same policy variable had to be manipulated in different, sometimes mutually contradictory ways in order to achieve them. A vigorous tax policy, for example, was called for to promote growth as well as social justice, but at the same time, tax concessions had to be offered for stimulating private incentives in a growing sector of the economy. Expenditure policy too had to be manipulated in somewhat inconsistent manner to suit these two objectives. The pattern of allocation of scarce government funds most suitable to achieve one objective was probably not equally contributory towards the achievement of the other.

III. Compatibility of Redistributive Justice with Rapid Growth: The Prevailing Orthodoxy.

There is clearly difference of opinion among economists as to the probable impact of greater equality in income distribution on rates of economic growth. Johnson, in the following citation, takes probably the most extreme position in this connexion:

> "There is..a conflict between economic efficiency and social justice.. An advanced country can afford to sacrifice some growth for the sake of social justice. But the cost of greater equality may be great to any economy at a low level of economic development that wishes to grow rapidly..It would therefore seem unwise for a country anxious to enjoy rapid growth to insist too strongly on policies aimed at ensuring economic equality and a just income distribution" (Johnson, 1968, p. 159).

Whatever limited empirical evidence there is, on secular changes in income distribution patterns in the now advanced countries is believed to show that in the early phases of their growth, income inequality widened and that narrowing of income inequality in those countries started at a relatively mature stage of their growth[19] (Kuznets, 1965).

The relevant empirical evidence pertaining to less developed countries has been examined recently by Adelman and Morris on the one hand, and a team of economists on behalf of the IBRD on the other. While Adelman and Morris argued that:

> "..there is no automatic, or even likely, trickling down of the benefits of economic growth to the poorest segments of the population in low-income countries. On the contrary, the absolute position of the poor tends to deteriorate as a consequence of economic growth" (Adelman and Morris, 1973, p. 189)

the IBRD study showed:

> "..the absence of any marked relationship between income growth and changes in income shares....It suggests there is little firm empirical basis for the view that higher rates of growth inevitably generate greater

19. One writer thinks that the recent experience of even Sri Lanka fits this pattern: "The very small difference in the concentration ratios between 1953 and 1963 may in part be attributed to the thesis that in the early stages of growth the shift in inequality is imperceptible or inequality may even tend to increase" (Karunatilake, 1974, p. 102).

inequality. This may have happened in particular cases but an explanation for this must be sought in the circumstances of each particular case and not in terms of a generalized relationship" (Ahluwalia, 1974, p. 6).

Thus researchers arrive at different conclusions through the interpretation of whatever scanty evidence that is available to them. The overwhelming weight of opinion today, nevertheless seems to be on the desirability of social equity even if it involves the sacrifice of some growth. Adelman and Morris for example, having argued that "..the policy instruments that are most effective in improving income distribution are different from those that are best for raising economic growth rates" (p. 185), go in search of development strategies which will combine redistributive justice with economic growth as policy objectives.

As has been noted, the rate of growth of per capita real income in Sri Lanka in the recent past has been very low. There has, however, been satisfactory progress towards less inequality in income distribution. The country's economic policy, moreover, has been one which sought to achieve economic growth simultaneously with redistributive justice. The above may appear to lead logically to the deduction that had Sri Lanka been less concerned with redistributive justice, it could have attained higher rates of economic growth[20]. By and large, local as well as foreign academic opinion seems to converge on the view that redistributive policies have been detrimental to bringing about the necessary conditions for "rapid economic growth in Sri Lanka. The views expressed in favour of this postulate may be broadly classified into three groups: (a) the savings argument, (b) the balance of payments argument and (c) the incentives argument. The validity of the fundamental propositions behind these arguments, however, is not adequately examined in the specific contexts of Sri Lanka.

III. 1. The Savings Argument

Discussions on, and attempts to plan, economic growth in recent years almost everywhere in the less developed world have been made within the celebrated Harrod-Domar model and its numerous variations (Streeten, 1972a, p. 71). The essence of this model is that the rate of growth of real national income is equal to the saving ratio divided by the incremental capital/output ratio. On this basis, a country's economic growth can be accelerated by raising the saving ratio, by lowering the incremental capital/output ratio or by both. As there are limits to output growth that can be achieved through lowering capital/output ratio alone, accelerated capital formation is made the *sine qua non* of rapid and sustained economic growth. This in turn requires a growing saving ratio.[21]

20. "The inability of the country to achieve a higher rate of growth, in some ways, could be linked to the social welfare policies..over a period of more than twenty five years" (Karunatilake, 1974, p. 88). "..the poor record of growth over the past..was not solely the reflection of Ceylon's inherent development difficulties. There is no doubt that public policy was and remains, in many respects, inimical to economic growth as the main emphasis was on redistribution, rather than on growth of income" (IBRD, 1966a, p. 16).

21. The following statement by a well-known development economist shows how fashionable it had been to emphasise the need for raising the saving ratio in order to step up the rate of economic growth: "The central problem in the theory of economic growth is to understand the process by which a community is converted from being a 5 per cent to a 12 per cent saver—with all the changes in attitudes, in institutions and in techniques which accompany this conversion" (Lewis, 1963, pp. 225-6).

Planning efforts in Sri Lanka have been very largely influenced by the Harrod-Domar model. In all the significant macro-planning exercises upto date, investment requirements were indicated to achieve the target rate of growth on the basis of a postulated capital/output ratio (Cf. National Planning Council, 1959, pp. 68 and 81-2; Department of National Planning, 1962, pp. 38-9; Ministry of Planning, 1971, pp. 22-3. See also IBRD, 1966b, pp. 14-15). It would be inaccurate to say that planners, policy makers and administrators believed that accelerated capital formation by itself was sufficient for rapid growth. They, however, emphasised capital formation and saving to the relative neglect of other necessary requirements for economic growth, probably because these other requirements were found to be rather difficult to quantify. Whatever that may be, it has been argued that the private sector as well as the public sector should restrain the growth of their "consumption" in order to save for rapid growth and future prosperity. Redistribution of income in favour of the poor who are assumed to be low savers, is asserted, on the one hand, to raise the household sector's propensity to consume. On the other hand, any government redistribution exercise involves an expansion of current expenditures and transfers which form part of public consumption. All this is to say that policies for social justice will lower the economy's overall saving rate thereby retarding its rate of economic growth.

Whether redistributive measures necessarily lead to low rates of saving depends on the answers to a complicated set of inter-related questions;

(a) Do the high income groups as a whole always save a higher proportion of their disposable income than the low income groups?

(b) What repercussions does a system of progressive taxation have on private savings?

(c) Is the government capable and prepared to raise revenues in relation to current payments which arise out of its commitment to social justice?

(d) What repercussions do its redistributive payments have on personal savings of their beneficiaries?

(e) How does income redistribution, through its impact on the demand for consumer goods, influence the saving-investment decisions of the private sector?

These and other relevant questions can only be answered through empirical research. A few country studies made recently appear to reject the hypothesis that there is a positive correlation between overall income inequality and the rate of aggregate savings (Griffin, 1971, pp. 8-11; Oshima, 1970, p. 126. A few more similar studies are cited in Mende, 1973, p. 144). These studies, of course, are insufficient to provide a firm empirical basis for an alternative hypothesis of general applicability. What is important to note here is that the relevant relationships have not yet been verified either way for Sri Lanka.

A government committed to social justice nevertheless normally allocates a part of the funds at its disposal for redistributive purposes. Even though it manages, at the same time, to maintain a high rate of saving and investment, one can still argue that some growth is sacrificed when scarce resources that could otherwise have been invested in capital projects, are used to redistribute income in favour of the poor. This conclusion again is not as straight-forward as is commonly believed. It depends on (a) the rates of return and the gestation period of the capital projects chosen, (b) how they are managed subsequent to commencement, (c) whether the funds released from the government current account did not have, in their original use, a growth stimulating impact and (d) if they had, the size of that impact relative to the growth stimulating impact produced by the alternative use of funds. The alternative growth path which might result from such resource reallocation cannot therefore be visualised purely on *a priori* grounds.

Particularly important in this connexion is the fact that the transfer of some funds from the government's current account will have adverse effects on people's work capacity and therefore on output growth. In the prevailing system of national accounting classifications, all government current payments fall into what is called public consumption.[22] As consumption expenditure in the orthodox scheme of thinking, makes no addition to the community's productive capacity, it may appear correct, as has sometimes been done, to argue that economic growth can be accelerated by pruning government current payments.[23] But a fair proportion of the so-called public consumption in Sri Lanka should be considered a form of investment on human capital.

One can guess that the proportion of Sri Lanka's active labour force who are below minimum subsistence level of living is not insignificantly small. It has been found that, of a sample of workers in a selected tea estate 36 per cent were anaemic with the corresponding proportions for males and females at 14 and 50 per cent respectively. The proportion of anaemic subjects in a sample drawn from a colonisation scheme was 32 per cent, with a proportion of 38 per cent for females and 29 per cent for males (Seneviratna *et. al.*, 1974: Seneviratna, 1974). Though no generalisation can be made on the basis of these small sample studies, malnutrition, under-nutrition and starvation are thought to be prevalent in different degrees among different sections of the active labour force. Anaemia, protein and calorie deficiency and physical weakness produced by these nutritional factors reduce people's work output.

22. The appropriateness of the Western macro-concepts of consumption, saving and investment in the context of a less developed country has been questioned by a number of writers (Myrdal, 1968, p. 19; Streeten, 1972b).

23. The following excerpt from a recent government publication presents this argument in its extreme form: "A policy of directing resources to consumption at the expense of economic growth does not augur well for a developing country like Ceylon as the attainment of high rates of economic growth would depend, to a very large extent, on the availability of resources for investment purposes. The internal resources required to exploit the growth opportunities cannot be generated so long as the government expenditure continues to stimulate consumption at the expense of investment.... The channelling of increasing resources for welfare expenditure in the context of a limited growth in revenue impairs the availability of resources for development expenditure.... It follows therefore that the welfare expenditure of government *must be pruned substantially* leaving considerable surpluses for the financing of development programmes." (Ministry of Finance, 1971, p. 56; emphasis added). Welfare expenditures above are the *total* expenditures on education, health, housing, special welfare services and the food subsidy (p. 59).

This argument is presented often in more moderate terms as follows:

"In addition to revenue policies, the government will have to reappraise existing policies governing current expenditures.... Some of them, such as free education for all from elementary school to post-graduate studies are generally considered to be essential elements of a modern welfare state. Yet Ceylon can ill afford them and perhaps it will be possible to consider some modification that would free some resources for investment and growth" (IBRD, 1966b, p. 19).

If it is a reasonable guess that a monthly income of at least Rs. 150/- was necessary for minimum subsistence living in 1973, the proportion of the total spending units with incomes inadequate to maintain minimum subsistence standards in that year works out to a not insignificant 19 per cent. It may also be noted that in 1973, 45 per cent of income receivers earned incomes of less than Rs. 150 per month (Central Bank of Ceylon, 1974, pp. 55-7). It has been estimated that a two-acre paddy holding was necessary to meet minimum subsistence requirements in 1969 (Jayaweera, 1973, pp. 24-5), but 83 per cent of total operators of paddy land in that year worked holdings of less than 2 acres (p. 47 below). All this implies that a fair proportion of Sri Lanka's work-force is below what may be called a "poverty line". As rice and wheat flour are the major sources of calories and proteins for the people of the country, the maintenance of government consumer subsidies on these and other foodstuffs *for the benefit of the lowest income groups* undoubtedly helped to maintain and probably improve their capacity to work.

Other growth stimulating items of public "consumption" were the developmental current expenditures, particularly those on education and health. By contributing to the development of human capital, they have had a significantly favourable impact on economic growth, though largely unquantifiable in the present state of knowledge. According to the Socio-Economic Survey of 1969-70, for example, 82 per cent of the total population over 10 years of age was literate with the corresponding proportion for males going upto 90 per cent. Of the total labour force, 84 per cent, moreover, had received some schooling. Particularly noteworthy is that these benefits from the expansion of government educational outlays have spread into rural areas./ It produced a peasantry more responsive to technological change and better methods of cultivation and made the government extension effort easier and more effective. The educational system moreover produced a growing number of engineers, technicians and other skilled personnel. The economy's capacity to design and successfully implement capital projects has, in consequence, tremendously improved.[24] On the other hand, the government expenditure on health services eradicated the debilitating diseases like malaria and reduced the morbidity rates within the labour force. The proportion of total population reporting sick in the two weeks prior to the above survey of 1969-70 was at a low level of 8 per cent.[25]

What the above arguments amount to is that certain government current payments too yielded positive rates of return. These rates of return may have been lower and less quick to materialise than those from alternative capital projects. If it were so, the allocation of scarce resources for such current purposes involved some sacrifice of growth, however small it may have been in net terms. But this sacrifice was made for a goal that was, in itself, a socially desirable one. It is therefore meaningless to concentrate so much on such possible conflicts between redistributive justice and economic growth as policy objectives. More meaningful exercise would have been to try to identify methods of promoting social justice which would have also produced favourable side-effects on economic growth.

24. One can justifiably criticise the pattern of education which existed in Sri Lanka. It produced wrong types of values and skills with obvious social costs. A more appropriate educational structure would also have involved an expansion of government expenditure on education.

25. This is not necessarily contradictory to the contents of the preceding paragraph. Conditions may have worsened as between 1969-70 and 1973-4. The studies referred to earlier were made in the latter period. In any case, people do not normally consider anaemia, calorie deficiency and protein deficiency as forms of illness until they become acute.

Government current payments on food subsidies, education and health did have built-in expansionary forces in the contexts of rapidly increasing numbers and their growing aspirations. Some major restraint could have been exercised on their expansion with no significantly adverse impact either on social justice or on the overall efficiency of the labour force by having been selective as to who should benefit from them and also by eliminating waste. What is objectionable is the argument that such payments should have been reduced simply to accumulate surpluses on the government current budget.

III. 2. The Balance of Payments Argument

Since the mid-fifties, Sri Lanka has been faced with a gradually weakening balance of payments and its external assets dropped consistently to rather precariously low levels. Inadequacy of foreign exchange earnings to import the essential consumer, intermediate and investment goods has become a serious growth constraint. In this situation the government growth strategy should have concentrated on measures likely to have led to a net foreign exchange saving (or earning): export promotion and diversification and import substitution.

It is argued that the strategy most appropriate for rapid growth in the underlying foreign exchange situation may be undermined by undue emphasis on redistributive justice (Marga Institute, 1974, p. 24).[26] Redistribution of income in favour of low income groups is likely to shift consumption patterns more towards food items. The proportion of expenditure on food and drink rises gradually with the fall in household income level.[27] Given the various structural bottlenecks and supply rigidities in the domestic food producing sectors, such shifts in consumption patterns are likely to become a further burden on the already weak balance of payments. As a result, scarce foreign exchange will be dissipated on consumer imports. "Developmental imports"[28] may therefore have to be cut down and consequently economic growth will suffer.

In addition to shifting consumption demand towards food items the redistributive policies are made responsible also for maintaining the aggregate level of domestic consumption demand at unrealistically high levels. Government current expenditures and transfers required to bring about social justice have grown more rapidly than its revenue. The small current account surpluses of the fifties gradually gave way to large current deficits. Government capital expenditure could therefore be maintained by running overall budget deficits, which were, in turn, financed through expansionary sources. Thus,

26. It is interesting to cite a passage from (de Silva, 1973) in this connexion though it is not directly relevant to the problem under consideration. "Ceylon has come to the end of the road of social welfare-ism; common sense plainly spells out that the welfare system must be abandoned or gradually dismantled. It is a predicament that is primarily the government's: in a parliamentary variation on the old game of musical chairs, it is the man who has leapt into a seat who is in a fix when the music stops. The music in this case is the balance of payments and external assets." (p. 93).

27. *See Socio-Economic Survey*, 1969-70, *Preliminary Report*, Table 40, p. 75.

28. Here again we come up against terminological inappropriateness in the underlying situation. Traditionally, imports of only raw materials, intermediate goods and capital goods are considered "developmental". But under conditions of fairly spread malnutrition and under-nutrition, imports of food to feed the workforce also should fall into that category.

due to redistributive policies and attendant fiscal mismanagement, the government had to allow "..purchasing power to run ahead of real income, during a period of adverse terms of trade and very low output growth..The overall, result has been that despite a high level of export earnings, the demand for imported goods far exceeded availability. Thus, once the inflated demand for imported consumer goods, mainly food, was satisfied the volume of capital and intermediate goods which could be imported in the absence of external assistance was sufficient to support only a low level of investment and less than full use and maintenance of existing assets" (IBRD, 1966a, p. 1).

The above reasoning against the package of redistributive measures is summed up in the statement that this made Sri Lanka "live beyond its means" (IBRD, 1966b, p. 1). It implies that the country had to import more than it exported mainly because consumer imports had to be maintained at unrealistically high levels in order to achieve redistributive justice. In an *ex post* reckoning, it is true that there was a widening trade gap since the late fifties. It is arguable, however, whether there was a direct cause and effect relationship between the policy emphasis on redistributive justice and the above phenomenon. It was no doubt a factor in the balance of payments equation, but only one among a few. The gradual worsening of the balance of payments position since the late fifties was caused by a complex set of factors which operated on both export earnings and import payments. Given the exports, a surplus in the trade balance could have been achieved by deflationary fiscal measures like the withdrawal of food subsidies and the facilities of free education and free health. Apart from the effects of such measures on socio-economic conditions of the poor, they would also have adversely affected the productivity of the labour force, the country's social and political stability and in turn, the rate of output growth. A low priority on social justice would have thus helped alleviate the payments difficulties but would not necessarily have improved the economy's growth performance.

To argue that redistributive policies were responsible for Sri Lanka's payments difficulties is to emphasise the obvious which need not be the most crucial one in a complicated problem. The more crucial factors in the equation are not so obvious and also difficult to handle—the weaknesses in the export structure, the deterioration in the terms of trade, structural rigidities in the domestic agricultural sector producing food for import replacement and the import-biased production structure of the import-substituting manufacturing sector. Once it is recognised that the country's payments difficulties are basically a structural problem, redistributive justice need not be looked upon as inconsistent with payments equilibrium and rapid economic growth.

III. 3. The Incentives Argument

Those who strongly believe in the efficacy of market forces argue that redistributive policies are inimical to rapid growth because they dampen private incentives. Of many redistributive measures, this criticism is mainly levelled against the food subsidies. "..the package of welfare policies was anti-growth..not so much because it competed with the development programme for *scarce capital* but because it removed *the incentives for growth and development* in the very sectors in which investments were being made. On the one hand, government was assigning high priority to its programme on new farmer settlements, on the other, its import policies and consumer subsidies were depressing the market prices for his products, The government was stabilising the cost of living but it was doing so by creating market conditions which were inimical to the growth and development of the peasant sector" (Marga Institute, 1974, pp. 19-20). With the recent achievement of self-sufficiency in potatoes, onions and chillies through price incentives created by import bans it seems, in retrospect, correct to argue in similar fashion against the import policies of the fifties. What is not taken cognisance of in this and many other arguments against redistributive policies is that the problem of accelerating growth at the same time promoting social justice could have been approached by the proper manipulation of a package of instruments like import measures producer subsidisation, consumer subsidisation, government revenue and expenditure measures and institutional and structural reform.

Redistributive policies, moreover, are thought to have destroyed the people's sense of independence and self-reliance. "The vast mass of the population saw the government as the powerful benefactor and cast themselves in the role of recipients. For the right development climate it is necessary to alter the relationship into one where the government is the main agent of development and where the people seek from government the conditions and opportunities for increasing their productivity and income earning capacity. This would mean a shift from the dependence on income transfers and subsidies to increasing self-reliance" (Marga Institute, 1974, p. 41). There is some inconsistency in this line of argument. If people are to expect the government to provide conditions and opportunities for increasing their productivity, they will continue to be dependent on government assistance. In any case, subsidies, whether the consumer or the producer variant, will have to continue to be a measure available for the government to provide these necessary conditions for private initiative. The call for self-reliance, nevertheless is meaningless in a system fraught with inequalities in income, opportunities and wealth.

IV. Objectives and Instruments of Policy

Within a democratic political framework, goals and objectives of economic policy are determined by the people. The economist's task is not to change the pattern of policy objectives and priorities so determined, but to examine the ways and means of achieving them most effectively and with a minimum trade-off. The economist who seeks a solution to a concrete policy problem, moreover, has to find it within the existing socio-political structure. Any radical change in it is the responsibility of the society and not of the economist.

The following discussion probes into whether it was not possible to accelerate economic growth in Sri Lanka in the recent past without sacrificing the goal of social justice. Though attention is drawn to policy alternatives that were available to policy makers in the past, the discussion is really intended to clarify policy issues facing the present generation.

Policy makers in Sri Lanka encountered certain difficulties in their strategy of growth with social justice. These difficulties arose out of two main reasons. Firstly, the authorities were not sufficiently imaginative to apply suitable selectivity criteria in the use of many of their policy instruments. Secondly, the number of instruments employed have been inadequate for the purpose in mind.[29]

Difficulties due to non-application of selectivity rules can be seen mostly in the case of the subsidy weapon—both consumer and producer variants. We restrict our discussion to consumer subsidies on food as they have, throughout their operation, been the most controversial in the growth-social justice debate. Consumer subsidies on food items have been intended essentially for redistributive purposes, despite their favourable side-effects on growth. If they had become an unwieldly redistributive instrument, it was due, among other things, to the absence of any selectivity in implementation until as late as 1972 when the free half measure of rice was restricted to non-income-tax-payers. Consumer subsidies on food are most needed for the lowest income families. It is not correct to be rigid in specifying an income level at which a family should qualify for the subsidy. Family size, its age distribution, place of residence, the prevailing rate of inflation and other factors would have to be taken account of in working out a suitable subsidy-entitlement level of income. It seems possible, however, that a fair proportion among even the non-income-tax-payers will be able to do without it. A few years ago, for example, the need may have been the greatest in the case of households with an income level of say, less than Rs. 200 per month.[30] Those who earned less than Rs. 200 per month formed 44 per cent of total households in 1969-70. Each of the 920,170 households within this income group consumed, on average, 37.01 lbs. of rationed rice per month—a total of 34.1 million lbs. per month. Total amount of sudsidised rice sold on the ration in 1969, according to the Food Commissioner, works out to 99.6 million lbs. per month. Thus, had the rice subsidy been restricted to households with income of Rs. 200 or less per month, the government would have saved as much as 66 per cent of its total rice subsidy bill. Even if it were restricted to those of incomes of less than Rs. 400 per month, the saving would probably have been in the region of 34 per cent of the total subsidy bill on rice.[31]

Practical, administrative difficulties in the application of an income criterion to choose those entitled for food subsidies would undoubtedly have been immense indeed but by no means insurmountable. Despite difficulties an attempt on the above lines should have been made to economise on the subsidy bill while retaining its effectiveness as a developmental weapon. The implementation of an income criterion would have been simple in the case of salaried classes. In the case of the large rural population falling outside this category, to evolve an administratively workable formula could hardly have been impossible. For example, the more well-to-do of the very large number of rural

29. A major principle in the theory of economic policy is that, as a general rule, there must be at least as many policy instruments as there are targets in order to achieve the latter with minimum trade-off. The existence of a solution to a concrete policy problem depends on the nature of the targets, the economy and the available policy instruments. If the policy makers in Sri Lanka were prepared to use more instruments, there is no *a priori* reason why growth target had to be sacrificed for the sake of social justice or *vice versa*. The more instruments, the less trade-off that is required (see ECAFE, 1971 and ECAFE, 1972).

30. After the more rapid inflation in the early seventies, a family should today be entitled to the subsidy even at a higher level of income. To work out a poverty line for Sri Lanka, which the above is all about, is a hazardous exercise with the available data.

31. The above calculations are based on the relevant data in (a) The Socio-Economic Survey of 1969-70 and (b) the Administration Report of the Food Commissioner.

boutique-keepers scattered all over the country and owners of cultivated land above a stipulated floor could justifiably have been made non-eligible for the subsidy.

The other areas in which the principle of selectivity could have helped to bring the volume of government current expenditures to manageable proportions were education and health. The higher income groups could have been made to pay for these services, with the proportion of the value of services paid for by these groups to increase with the rise in the level of their income. It has been noted above that the redistributive policy in Sri Lanka was mostly beneficial to middle-income groups whereas such benefits should really have gone mainly to low income groups. Some selectivity in current "developmental" expenditures would have produced this desirable latter effect.

The heavy burden of food subsidies on government finances is only part of the orthodox argument against them. They are also claimed to have weakened production incentives and aggravated payments difficulties. The application of suitable selectivity criteria in the implementation of the subsidy weapon would have freed the major section of the market for staple food items from price controls and rationing. This would have produced a rise in their prices in the open market, thereby providing the necessary stimulus to expand domestic production. Owing partly to payments difficulties and partly to stimulate production incentives further, restrictions on the import of these food items would have become necessary at varying degrees.

Here the level at which the government determined its purchase price to obtain the products concerned from the local market for subsidised distribution among the poor classes would have been crucial for the success of the whole scheme. The significance of this factor is underlined by the recent experience with the farmers' unwillingness to sell their paddy to the Paddy Marketing Board. In determining a realistic purchase price the government should have been particularly concerned about the prevailing foreign exchange scarcity. It is a practice nowadays to use the world market price to indicate the real worth of a domestic substitute. If this practice were adopted here the rupee equivalent of the world market price of the products concerned should have been calculated at some shadow exchange rate reflecting the real scarcity value of foreign exchange.

High realistic purchase prices for food crops, however, may have offset, at least in part, the economies which could have been effected through selectivity in current developmental transfers and expenditures. In the long-run, however, food prices might have come down with the expansion of output and the improvement in productivity in the domestic food-producing sectors. But initially the fall in the government current payments within the policy framework outlined above would have been rather marginal. This is a problem which should have been tackled from the government revenue side as will be pointed out presently. The higher incomes for the bulk of the population which would have resulted from higher producer prices for food crops and the relief afforded to lower income groups through redistributive measures would have produced favourable market conditions for the growth of the rest of the economy.

A fair proportion of the difficulties faced by the government during the post-independence period in its strategy of growth with redistributive justice can, however, be attributed largely to the inadequacy of its revenue efforts. As has been noted, the growth of revenue was inadequate in relation to the growth of requirements. There was probably very little more the government could have done in the field of indirect taxation to accelerate the growth of its revenue. The same comment does not seem to apply, however, in the case of direct taxation. As the published income tax data do not furnish the information we require, there is no room anyway for firm conclusions in this respect.

Income tax collections are classified on the basis of five types of taxpayers—resident individuals and companies, non-resident individuals and companies and a miscellaneous group. The breakdown of the income tax revenue into these five groups for 1958/9-1959/60 and 1968/9-1969/70 is given in Table 5 below. Although a classification of the tax revenue by income-source is not available, statutory and assessable incomes are so classified. Some rather weak conclusions can be drawn on the basis of this information together with the data in Table 5.

A growing share of the revenue from income tax was contributed by resident individuals. As 60 per cent of total assessable income of resident individuals was from employment, the relatively rapid growth of revenue from resident individuals seems to have come about mainly through the taxation of salaried classes. Given the difficulty of tax evasion in the case of these groups this

TABLE 5

**Classification of Income Tax Revenue—
Averages for 1958/9—1959/60 and 1968//9—1969/70**

	1958/9—1959/60	1968/9—1969/70
Total Revenue from Income Tax (Rs. Million)	512.6	919.2
Of which: Per cent		
(a) Resident Individuals ..	20.0	38.8
(b) Non-resident Individuals ..	1.8	1.1
(c) Resident Companies ..	37.8	41.0
(d) Non-resident Companies ..	31.8	7.6
(e) Miscellaneous, Unclassified and Additional Assessments ..	8.6	11.5

Source: *Administration Report of the Commissioner of Inland Revenue*

is quite understandable. A fair proportion of the growth of revenue from individual taxation may also have come from private traders whose share of total declared individual assessable income rose from 25 to 28 per cent between 1958/9-1959/60 and 1968/9-1969/70. It is undisputable that the bulk of the "domestic agricultural" activity has been in the hands of individuals and that at least a small proportion of this peasantry have become prosperous in recent years. Though the available data do not permit a strong conclusion with regard to this matter, it appears that even these prosperous sections of the peasantry were largely exempt from income taxation. Of total declared individual assessable income, the share of agriculture dropped drastically from 25.6 to 6.0 per cent as between the two periods mentioned above. There is undoubtedly a strong case for direct taxation of agriculture, both export and "domestic", within an economy where one-third of the GNP is produced within that sector. If the government were to adopt policies of the type discussed above, taxation of agricultural producers on similar formulae adopted in the case of other citizenships would have become reasonable. As the possibility of tax evasion is greater here than elsewhere in the economy, some alternative form of progressive agricultural taxation might have been evolved as a substitute second-best measure.[32]

Table 5 also shows that the share of income tax revenue from resident companies increased slightly over the period under consideration. A point of some relevance here, which again cannot be strongly substantiated with the available data, is that the growing share of these companies in income tax revenue is likely to have been due to the conversion of many non-resident companies into resident ones by change of registration. Otherwise the fall in the share of the latter by one-fourth cannot be fully explained. Under the income tax laws prevalent in the last decade, the bulk of resident companies in manufacturing business were enjoying attractive tax concessions. The granting of these tax concessions to the manufacturing sector which was growing fast within a captive market and was earning high profits was an unrealistic measure in the contexts of growing revenue requirements. The growth of manufacturing activity since the early sixties could hardly be attributed to these tax incentives. There was no such growth in the fifties, despite very attractive tax concessions offered in the early part of that decade. As sufficient growth incentives were provided by way of a safe market and high prices through extensive import and exchange controls, tax concessions were largely superfluous.

Thus whatever growth there was in the revenue from income taxation appears to have been due largely to heavier incidence of taxation on a broadly similar category of taxpayers and to the growth of their incomes. For various political, economic and administrative reasons, a large and growing sector of the economy remained largely outside the purview of direct taxation.

The principal economic reason for the above has been the alleged need of fiscal incentives to stimulate output growth. Views differ, as they should, as to how far these tax concessions are necessary to maintain and stimulate incentives for growth in the affected areas.[33] The issue must be settled by careful and rigorous examination of all relevant facts. The government used a number of measures to stimulate incentives—insulation of the domestic market from the competition of imports, producer subsidisation, provision of infrastructure, input subsidisation and, in some cases, convertible rupee accounts. All these measures carried heavy social costs. It seems nothing but reasonable to have charged some of these costs to the private accounts of the beneficiaries.

32. If income taxation is not practicable, the next best means of agricultural taxation is to tax the harvested production. Tax evasion cannot be successfully prevented even here without an intricate and widely dispersed administrative machinery. The costs of such an administrative machinery can be very high relative to the increment to revenue that can be expected. Land taxation too has many obvious weaknesses. The income of an agricultural family cannot always be approximated by the extent of land it owns. A given area of land may yield differential income levels depending on its location, the crops grown, prevailing weather conditions, infrastructural facilities and agricultural technology adopted. Land taxation, moreover, has a rather unfavourable history in many countries. Under conditions prevailing in Sri Lanka, the choice of an effective, economical and equitable form of agricultural taxation requires ingenuity. It is bsically a political and administrative problem.

33. The proposal made in the Budget Speech for 1975 to withdraw some tax concessions from the manufacturing sector has sparked off a debate between the Finance Ministry and other affected parties regarding the possible impact of the proposal. While the Finance Ministry takes the view that these tax concessions are superfluous, others maintain that their removal will destroy incentives for further growth. See e.g. *Ceylon Daily News*, Dec. 28, 1974 and Jan. 27, 1975.

The relationship between the government and public corporations also deserves some comments in connexion with the inadequacy of the growth of government revenue. Upto the beginning of the seventies, there has not been any net *direct* contribution to the government budget from public corporations, despite their indirect contribution in the form of taxes on their production and sale. By the early seventies, a large proportion of the corporations sector was at least ten years old but still it was heavily dependent on government funds for capital formation.[34] Government capital transfers to corporations in 1971/2 amounted to 8 per cent of total government revenue. Of the different payments items given in Table 2 and 3 above, capital transfers to corporations registered the highest rate of growth during roughly the 1960's. Had the government made it a policy not to subsidise the relatively mature corporations and made at least the more profitable ones among them contribute directly to government revenue, the difficulties it encountered in budgetary management could have been reduced to a significant extent.

V. Conclusion

The paper is written on the fundamental value judgement that economic growth and social justice are equally significant policy goals. It is therefore meaningless to argue that the latter objective should be abandoned or a clearly low priority assigned to it in order to achieve more rapid economic growth. Both are essential for social welfare, the improvement of which is what the economic policy is all about. The main theme developed here is that the government of Sri Lanka failed to achieve both these objectives satisfactorily because the policy framework within which it operated was inadequate for the purpose.

Those who stress the conflicts between the two objectives and suggest that social justice should be sacrificed in order to accelerate economic growth deal mainly with fiscal aspects of public policy. The present inquiry has therefore been restricted to that specific area. In order to find an adequate policy mix to achieve rapid economic growth with social justice, a government should, however, go much beyond the limited area of governmental fiscal activity. Institutional and structural reform, which falls clearly outside the traditional fiscal-monetary policy framework, should be identified here as a majoi policy area to concentrate on in the formulation of a development strategy intended to achieve economic grcwth with social equity in the contexts of a less developed country like Sri Lanka.

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34. In 1972, capital formation in public corporations amounted to Rs. 319 million while the government transferred to them on its capital account, over a period of 12 months in 1971/2 (on a pro rata basis), a sum of Rs. 258 million. To relate the total capital transfers to public corporations in a given year to their capital formation in that year is, of course, somewhat irregular. Only a part of such transfers is invested by the corporation in the current period. The remainder is partly to cover the losses incurred by some corporations and partly to write-off some of their previous loans from the government.

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