PN-ABQ 006

Cornell Food and Nutrition Policy Program

The Politics of Food Policy in Sri Lanka: From Basic Human Needs to an Increased Market Orientation

David E. Sahn and Neville Edirisinghe

CFNPP Reprint SERIES

Reprinted from Pinstrup-Andersen, Per (ed.), David E. Sahn and Neville Edirisinghe. 1993. "The Politics of Food Policy in Sri Lanka: From Basic Human Needs to an Increased Market Orientation." In The Political Economy of Food & Nutrition Policies. The Johns Hopkins University Press, Baltimore/London.

3 The Politics of Food Policy in Sri Lanka: From Basic Human Needs to an Increased Market Orientation

DAVID E. SAHN AND NEVILLE EDIRISINGHE

Introduction

Economists have long debated what strategy will best promote the primary goals of development: economic growth and equitable distribution of income. The fact that a cornerstone of this debate has been the assertion of the incongruity of these objectives has often served to polarize both economists and policy makers into those concerned primarily with growth and those concerned with equity (Kuznets 1972; Adelman, Adelman, and Taft 1973). This dilemma has been further fueled by confusion over how to realize either aspiration.

During the past few decades, the profession witnessed an evolution of ideas on how the objectives of growth and equity are best achieved. One school of thought reflected in the policies of many countries, is that government should intervene strongly and pervasively in the economy. The state is considered to be best equipped to optimally allocate scarce resources for the good of all while fostering the necessary social and institutional changes required to bring about self-sustaining economic growth. Such an approach often leads to a set of policies that include a high level of protection for domestic manufacturing, a plethora of state-owned enterprises, price controls on most, if not all, major commodities, and high levels of government recurrent expenditures devoted largely to maintaining political power, be it through expanding the influence of the military or by subsidizing food to gain favor with the populace. The emerging consensus is that many of the state-run economies have been racked by inefficiency, corruption, and distorted allocation of productive resources. This has retarded the transformation of society as originally envisaged.

Disappointment with the effects of major intervention by the government in the economies of developing countries has given rise to other ideas on how best to foster prosperity and equity. Liberalizing the economy through the reduction of state controls and ownership has assumed a new position of prominence. The tenets of such an outward-looking strategy have been embraced by many countries (Krueger 1980). Ideas currently in use include opening up international trade by removing state protection of industries and promoting exports, decontrolling prices and reducing subsidies, promoting fiscal restraint, eliminating state-owned industries and enterprises, removing cumbersome banking controls, and promoting rational capital markets to encourage savings and more propitious investments.

The extent to which government policies reflect this changing wisdom varies widely among countries. Sri Lanka is one nation that has unquestionably been strongly affected. A reorientation is manifested in the major macroeconomic changes that began in 1977, when a new political party assumed power. Although the new government moved toward a more market-oriented economy, it remained a major actor in the economy as manifested in the growing level of government borrowing and investment from 1977 onward. Thus, while we will show that policy changes in Sri Lanka do not strictly conform to the tenets of a structural adjustment toward a completely liberalized economy, the reordering of priorities away from welfarism and toward economic growth is perhaps nowhere more evident than in the arena of food policies. Similarly, the results of these macropolicy shifts are of greatest concern, as manifested in the food intake and nutritional status of the population. Therefore, this chapter examines the transition of development philosophy in Sri Lanka, focusing on the implications of food-subsidy policy changes for the poor. In particular, we concentrate on the shift from a basic human-needs approach, characterized by extensive government intervention in the economy and large food subsidies, to a more market-oriented approach whereby economic growth itself is expected to provide benefits to all members of society through the market mechanism.

In examining this transition, a political economy perspective is employed. The focus is on the social processes and institutional mechanisms that bring about change. Understanding the nature of these changes in a context broader than mere descriptions of the policy reforms can provide is vital, given that economic liberalization is politically difficult; inevitably, major macropolicy reforms will have immediate losers as well as gainers. In the case of Sri Lanka, it is suggested that the poor—those who had benefited most from heavy government intervention, especially in the food sector—may be the short-term losers. The questions remain whether the poor stand to gain enough over time to compensate for any short-term dislocation and how and with what efficacy has the political process responded to mitigate any potential deleterious short-term effects of macroeconomic changes on the standard of living, especially of the poor.

The Origin of Social Welfare and Food Policies in Sri Lanka, 1948–1977

The recent political economic history of Sri Lanka began with independence in 1948, after nearly 450 years of foreign rule. It was, however, during the last 150 years of colonial rule under the British that the major structural

2

transformation of the social system and economy occurred. This change, in the words of dependency theorists, represented a distortion of the ecological, social, and economic structure of the island. It fully entrenched the export-oriented plantation economy. The three tree crops—tea, rubber, and coconut—accounted for more than 90 percent of the total export earnings at the time of independence (Herring 1981). Therefore, the country was overtly subject to the vagaries of international prices for three primary products. This fact was to remain a permanent fixture of the Sri Lankan economy, as manifested by the fact that in 1984 these tree crops still accounted for 57 percent of the country's exports (Central Bank of Ceylon 1984). Concurrently, the competition for natural resources and capital between the modern capitalist sector and the traditional low-productivity peasant sector was a classic example of a dualistic economy.

Of equal importance was the legacy of democracy that the British left behind. By the time of independence, Sri Lanka had experienced many years of universal suffrage. A commitment to parliamentary democracy became a cornerstone of the political context in ensuing years.

In addition to colonial rule, the events of the Second World War were important in terms of influencing development, food policy, and food subsidies, whose evolution is the focus of the remainder of this chapter. Specifically, food-related transfer payments were a direct legacy of the war. They originated in 1942, when rice rationing commenced in deficit areas because of interruptions in normal import channels due to the global conflict (Edirisinghe and Poleman 1976). Soon rationing of food, which was to protect consumers from soaring prices, spread throughout the island nation. In the decades that followed, the food subsidy grew steadily and remained at high levels until the economic changes that occurred in the late 1970s.

In assessing the growth of the subsidy scheme between 1942 and 1977, a few domestic and international events serve to illustrate the interplay between politics and economics, which led to the formulation of a food policy in Sri Lanka. The maintenance of the welfare program during the period 1948–52 was assisted to a large extent by the boom in the economy induced by the Korean War. Exports fetched high prices and the balance of payments was favorable. This trend reversed in 1952 and resulted in the contraction of trade, worsening of the balance of payments, and depreciation of the rupee. By mid-1952, the import price of rice had increased sharply. The government realized that the budget deficit, partially attributable to food-subsidy expenditures, was becoming a serious burden. At this time, the size of the basic rice ration, which was kept constant at three pounds per person per week since 1948, was reduced by one-half pound per household, but there were no changes in prices.

The most sweeping changes in the subsidy program occurred in 1953. The government's overadherence to an International Monetary Fund (IMF) proposal to phase out the subsidy scheme resulted in a price increase of nearly 300 percent on rice rations. At the same time, postal, telegraph, railway, and electricity rates were also subjected to substantial price hikes. These measures, particularly the ration-price change, became the target of the *Hartal*—a massive protest launched mainly in urban areas. The immediate outcomes were civil disruptions, a few deaths, damage to state property, and increase in the ration entitlement at reduced prices, and the resignation of the prime minister. These events marked the beginning of the "rice issue," which was to loom large in almost every major political campaign in future years.

The elections of 1956, in which the ruling center-right United National Party (UNP) was defeated by a powerful coalition of Marxist and non-Marxist central-left parties led by the Sri Lanka Freedom Party (SLFP), reaffirmed a role for a consumer-oriented food policy. Emphasis was placed on "planned" economic development, socialization and Ceylonization of productive resources, and state patronage to directly assist the poor and the middle class. Relief to the poor was provided through reduction of rice and sugar prices, increases in health and unemployment benefits, village expansion, and colonization schemes. These welfare-oriented policies were reaffirmed by the electorate in 1960. The state grew more powerful, more egalitarian; distributional policies were adopted and welfarism continued to grow.

In the 1965 general elections, food was not a major issue. Rather, the focus was on more ideological concerns, such as the role of the state and freedom of the press. Government did change hands; a coalition led by the United National Party (UNP) ruled from 1965 to 1970. Shortly after this change, however, the focus on food subsidies resumed. Rice prices had soared by 1966 due to a shortfall in world rice output against a backdrop of increasing world demand. These exogenous events once again contributed significantly to balance-of-payment difficulties. An element of economic reality was the IMF conditionality that expenditures on social services be restricted. In December 1966, domestic policy responded to the changing international climate: the basic ration was cut by one half and issued free of charge. This was a strategic compromise between economic reality and political feasibility, the latter of which was necessitated due to the public's long-standing expectation that rationed rice would be available at subsidized prices. The result of the reduction in the ration was a substantial decline in imports. Per capita imports of rice, which averaged 46 kilograms between 1960 and 1966, declined to 29 kilograms between 1967 and 1971. Subsidy changes were accompanied by a massive campaign to intensify domestic rice production.

The changes in 1966 are significant in several respects. First, somewhat drastic subsidy reductions were not followed by food riots. These cuts were preceded by a declaration of an emergency in order to reduce the potential for adverse reaction among the population. In addition to this precautionary action, the decision to provide the remaining ration free of charge may have dampened initial protests over the subsidy cut. At least in the short run, the free issue of rice was able to partly offset the real-income losses due to the cut in the subsidy.

Second, the rice-intensification program that accompanied the subsidy cuts brought to light the crucial role that technological change can play in expanding agricultural production. New varieties of rice accounted for 43 percent of rice production in 1966. By 1970, this proportion had increased to 70 percent. Between 1960 and 1970, paddy production increased by 70 percent. The key to this success, as manifested in the high rate of farmer response to new high-yielding varieties, was undoubtedly facilitated by the relatively high rates of literacy brought about by social welfare programs.

The rice ration was once again a dominant factor in the election of 1970. Restoration of the rice subsidy was a major promise of the center-left coalition, and this coalition registered a landslide victory. One of the first actions of the new government was to restore the size of the weekly rice ration to four pounds. Before long, the global world food shortage was beginning to affect the cost of imports. As a result, by the end of 1973 the basic ration was reduced by 50 percent despite the strongly espoused commitment to social justice and economic equality. At the same time, the guaranteed price to the farmer was increased by 40 percent. A long-term solution to the vagaries of international markets was sought through intensified efforts to increase domestic food production.

While the above discussion focuses on the role of the political process in the growth and maintenance of food subsidies for the past 30 years of Sri Lanka's history, it must be seen in the larger context of a commitment to welfarism. This was displayed in the widespread health and education coverage on the island. In comparison with other countries, the share of GDP allocated to health and educational services was not exceptionally high. However, the government orientation placed emphasis on widespread coverage of these programs. This is largely reflected in the share of health and educational financing assumed by the government, which was markedly higher in Sri Lanka than in other nations (Richards and Gooneratne 1980).

The performance of Sri Lanka in pursuing policies to meet basic human needs has received pervasive attention from academicians and policy makers alike. Suggestions that Sri Lanka has distinguished itself by the "general political commitment to the poor majority" (Gwatkin 1979a) or that it has achieved "remarkable social progress for a country with a very modest economic base and relatively low per capita income" (Gavan and Chandrasekera 1979) are indicative of the types of praise given during the 1970s. Much of this was a result of the high literacy rate, low infant mortality, and long life expectancy that singled out Sri Lanka from all other nations of comparable per-capita income (Morris 1979). In turn, it has been strongly argued that such accomplishments were largely attributable to the welfare policy in general and the food subsidy policy in particular (Isenman 1980).

Despite the global recognition of Sri Lanka's accomplishments in the area of social welfare, some have expressed doubts about the success that Sri Lanka achieved. In this regard, the sentiments that "Sri Lanka has not been the model example of the application of a basic needs strategy" (Richards and Gooneratne 1980) must be considered.

Specifically, it has been suggested that social welfare policies were implemented coincidentally with policies that impeded economic performance in general and growth in exports in particular (de Melo 1981). In addition, Bhalla (1986) asserts that it was the initial level of literacy and low mortality rates at independence, rather than the social welfare expenditures between 1960 and 1977, that brought about exceptional levels of basic-needs accomplishments. This contention has been disputed by Sen (1986), who argues that the social expenditure of the government did indeed contribute to the long life expectancy and high level of literacy in Sri Lanka. He also points out that while eliminating all expenditures on health, education, and welfare would have doubled the annual rate of GDP growth, such a scenario is unrealistic and the actual rate of 2.4 percent between 1970 and 1977 was better than that of many of Sri Lanka's South Asian neighbors (Sen 1980).

It may also be posited that there is a relationship between expenditures on nutrition, health, education, and growth. The reduction in fertility rates, for example, was partially attributable to high literacy rates coupled with low infant mortality and increased receptivity to family planning. The food ration also provided a sort of insurance against disability in old age. This concept of the subsidy as a form of insurance may have also reduced the risk-averse behavior of farmers, as well as disaccumulation in years of poor harvest or during the lean season (Richards and Gooneratne 1980). This, in turn, may have increased farmers' receptivity to adoption of new technologies (Sen 1980).

It is beyond the scope of this chapter to resolve the opposing viewpoints concerning the actual performance of the Sri Lankan economy prior to 1977 and the efficacy of social welfare expenditures. In addition, the question remains as to whether and to what extent the redistributive policies of the government could have been implemented without the market distortions that were extant. It is clear that tea taxes paid for much of the food imports used in the quantity rationing scheme (Thorbecke and Svejnar 1987). Could this revenue have been raised through other means? And could a variety of other policies, such as reducing government involvement in corporations and removal of many trade barriers, have been adopted concurrently with high levels of social expenditures?

Despite the difficulty in presenting a counterfactual argument as to what would have transpired in the economy without the food subsidy and other pillars of the welfare policy, it is clear that both exogenous events, such as the oil shock, world food crises, and low tea prices, and domestic policy choices in terms of reducing the efficiency of markets contributed to a slow rate of growth during the early 1970s. The taxation of the plantation sector, which provided the needed capital to finance Sri Lanka's welfare programs, further squeezed this sector and provided disincentives to greater investment. Other actions, such as the process of moving toward nationalization of the plantations, land reforms, and expropriation of private businesses, may have also contributed to the stagnation of private investment. Nevertheless, the improvement in the terms of trade from the trough in 1975 witnessed a commensurate increase in economic activity in 1976 and 1977 prior to the election. This trend, however, was not sufficient to dissuade Sri Lankans from voicing their disaffection with the state of economic and political affairs.

In 1977, the voters peacefully brought about a change in government. The leftist coalition built around the SLFP was succeeded by the UNP. The mandate for change was overwhelming. However, some compelling questions arise: What are the characteristics and circumstances that resulted in such a smooth transfer of governmental power in 1977? How did the new government succeed in taking such politically precarious moves as drastically reducing food subsidies, decontrolling prices, and devaluating the currency?

The most important characteristics of the transition from a welfare oriented to liberalized economy were the broad consensus among the people that the performance of the previous government had been unsatisfactory in spite of the commitments to welfare and the democratic heritage that allowed the people to vote for change. The inability of the economy to provide sufficient employment opportunities was a key factor. Mismanagement of the growing number of government-owned institutions and discouragement of private-sector initiatives contributed to unsatisfactory levels of productive employment. Controls on trade, shortages of consumer goods, long lines to purchase essential goods, and the existence of black markets all contributed to a general discontent among the electorate (Moore 1985). The disincentive effects were nowhere harder felt than among the large capitalist class, whose economic activity was curtailed in an era of nationalization, currency restrictions, and state-controlled industries. Thus, the leftist coalition, dominated by the SLFP until it was dismantled in 1975, confronted a series of internal and external political and economic events that resulted in a growing dissatisfaction.

The economic picture, coupled with the fact that the left-of-center coalition was both divided and in disarray, resulted in a political crisis that the UNP capitalized upon by providing a platform where abundance of consumer goods, employment opportunities, and elimination of corruption were promised.

The Postliberalization Period

Following the national elections of July 1977, the UNP acted promptly in bringing about macroeconomic changes designed to fuel economic growth. Such efforts revolved around institutional changes and reforms of policies designed to liberalize trade, provide incentives for productive investment, and increase domestic savings. Associated with these reforms were many "lead projects," entailing heavy capital expenditures that were expected to provide the infrastructure for development.

There are numerous features of the government's actions, some initiated immediately and others phased in over longer periods of time. For example, the government undertook promotion of institutional change through a variety of initiatives, including the formation of several new government agencies to guide and encourage both domestic and foreign private investment (U.S. Agency for International Development 1982). In addition, major policy changes were undertaken. These included (Nelson 1985):

1. Immediate unification of the exchange rate at a level that represented a sharp depreciation of the currency; the currency was also allowed to float.
2. Elimination or reduction of price controls on all but a few select commodities, for example, rice, flour, bread, sugar, coconut oil, kerosene, and bus and rail tickets, that were then decontrolled in phases over the next couple of years.
3. Change in the structure of tariffs to allow for some protection of domestic industries that heretofore were protected by a combination of an overvalued exchange rate, quotas, and exchange controls.
4. Phased adjustments in interest rates in 1977 and again in 1980 to more closely reflect the real prices of capital and thereby encourage savings; and the establishment of a National Development Bank in 1979 to improve the flow of credit.
5. Movement toward elimination of public-sector import monopolies except for certain commodities, such as rice.
6. Reductions in corporate tax rates and tax incentives such as special depreciation provisions.
7. Establishment of free-trade zones to encourage foreign industrial investments.[1]
8. Targeting of the food-ration system to only the lower half of the income distribution beginning in January 1978, followed by the introduction of food and kerosene stamp programs tied to a fixed nominal value beginning in September 1979.

In the transition from one political era to the other, a coherent package of policy reforms and a well-developed strategy to turn around economic stagnation was thus presented and operationalized by the UNP.

1. It is also noteworthy that despite these major policy and institutional changes, the number and role of public-sector corporations were not reduced significantly. Rather, emphasis has been on improving the efficiency of these corporations while encouraging new productive investments in the private, instead of public, sector.

It is noteworthy that the reduction in the food-subsidy scheme did not bring about the vociferous opposition that occurred during previous attempts to reduce the program. The question is why. The first, and most prominent, reason is that the government did not advertise its intention to remove the most politically sensitive element of the welfare state—the food subsidies. In fact, the new government actually increased subsidies by decreasing the subsidized price of the rice ration after a few weeks in office (Nelson 1985). Thereafter, the process of strategically phasing down food-related income transfers began. Thus, although there was an overwhelming call for new leadership in Sri Lanka, the removal of the food subsidy was not on the platform of the UNP. Only well after the elections, when the country was already responding to the changing economic environment, did the food subsidy in the form of the quantity rationing scheme meet its demise, although this was brought about gradually to mitigate any adverse political consequences.

To amplify, it was not until January 1978 that the government implemented new regulations to disqualify the upper half of the income distribution from receiving subsidized food; the quantity rationing scheme was restricted to the lower half of the population after a means test. This change was preceded by a vast publicity campaign to show that such changes were required to generate more employment. A second phase, one and a half years later, involved the change from ration shops to food stamps. Under similar eligibility criteria, households could receive food stamps whose value was set in nominal terms, which at the time of the transition exceeded the value of the subsidy from the old quantity rationing scheme. By not indexing the value of the stamps to the cost of living or the price of rice, it assured that fiscal costs of the program would be contained. In addition, the inflationary environment gradually diminished the real value of the transfer to the consumers without the need for any government proclamations or further policy adjustments.

The second reason for the new government's successful reduction in the food subsidy bill is that there was little or no concern over the possibility that the sentiments of the urban population would be aroused by Marxist-oriented political parties. The left-wing political parties had been completely rejected at the 1977 general elections. Their power in the trade unions was eroding due to the strength of the newly organized progovernment trade unions. The first truly concerted effort to protest against the rising cost of living by the leftist-oriented trade unions in 1981 was firmly handled by the government. For the first time in trade union history, over 40,000 protesters lost their jobs.

Third, on the electoral front, people were given the opportunity to express their confidence or nonconfidence through a presidential election in 1982 and a referendum in 1983. These were different from the usual format of the parliamentary general elections that have witnessed regular changes in government. For many, voting at the general elections was a show of confidence or nonconfidence in past experiences of localized patron-client relationships. In the presidential elections, it was a choice of a leader for the whole nation. National issues and the personal popularity of the incumbent president were perhaps more important elements in the presidential elections. Although the rising cost of living and the impact of subsidy cuts were the major issues focused upon by the opposition, at the presidential election there was a comfortable victory for the ruling party. This particularly reflected the view of many voters that early positive effects of economic reforms outweighed the more recent negative effects of the elimination of the food ration and other welfare losses.

The real substitution of the general elections was the referendum held in 1983 to prolong the life of the existing parliament for another six years. In this instance, the referendum did not even involve voting for a candidate but instead was a vote of yes or no to continuation of the existing parliament. The referendum gave rise to a debate on many economic and noneconomic issues, but it apparently lacked the form and spirit found in earlier general elections (Silva 1984). The people had already voted for the leader of the ruling party a year before. There was little or no surprise when the referendum supported continuation of the legislature under the president's control.

In sum, the newly elected government reacted quickly to its overwhelming mandate and took strong measures to reverse the slow growth of the economy in the 1970–1977 period. In this case, free elections brought about political change that enabled economic liberalization and decontrols to gain a strong foothold in Sri Lanka.

The Effects of Liberalization

The success of the economic liberalization scheme can be measured by many indicators. The most visible statistic has been the impressive rate of growth in GDP during the late 1970s. The real growth of 8.2 percent in 1978 and 6.3 percent in 1979 leveled off to around 5 percent between 1982 and 1983.[2] The growth in agricultural GDP grew at a rate of 4.3 percent compared with 1.85 percent from the 1970–1977 period. Similarly, unemployment dropped from 14.8 percent in 1978–79 to 11.7 percent in 1981–82, only three years after the change in government (Central Bank of Ceylon 1984). The unemployment rate recorded for 1970 was around 15 percent and rose to 24 percent during the world food crises of 1973 (Sahn 1986).

In terms of the effects on social programs, food-related income transfers, and investments in human capital, the data indicate the dismantling of the welfare state, especially in the food sector. There was a dramatic decline in the percentage of the GDP and recurrent expenditures devoted to food subsidies as well as in the real value of the subsidies to the consumer. Expenditures on

2. These rates of growth may be overstated because of technical problems with the accuracy of the deflators used in their calculation by the Central Bank (see Bhalla 1985).

10

education and health care have also declined as a share of total expenditures, although considerably less than the food-related income transfers.

The question remains as to what extent the increase in the growth rate over the late 1970s reflects the fact that liberalization was accompanied by a precipitous increase in the flow of resources from international institutions to Sri Lanka. The comparatively low level of investment in the preliberalization period was partially attributable to acutely low levels of foreign aid (Sen 1980); just the opposite was the case after 1977. In fact, the net foreign financing of the cash deficit increased in real terms from 582 million rupees in 1977 to 1,992 million rupees in 1981. In dollar terms, total aid commitments rose from $250 million in 1977 to over $600 million in 1980.

Around one third of the assistance was outright grants, while the remainder was low-interest long-term loans.

This voluminous increase was not indicative of what was transpiring in neighboring Asian nations. The lesson here is that adopting a policy set that was compatible with the basic principles of international lending institutions reaped major benefits in terms of availability of capital. This led to increased economic activity, amply manifested in rapid growth of the GDP directly after liberalization. As argued by Herring (1981):

> International factors in the new strategy, thus, become critical; international support in material terms has arguably been a necessary condition for the liberalization initiatives. The international development community has provided resources to tide the regime over the potentially rocky re-adjustment period.

Concurrent with the increase in foreign investment and grants, the period from 1977 to 1979 was characterized by a recovery of international tea prices, a major source of foreign exchange in Sri Lanka. The overall improvement in the terms of trade was dramatic. Furthermore, the Keynesian effects of removing controls stimulated demand, which was previously constrained by import restrictions. This, too, contributed to an increase in the growth of GDP. So while there is little question that the origins of the improved economic performance were in the reforms adopted by the UNP, international lending facilities and a favorable international climate in the immediate postadjustment period facilitated economic growth.

The postliberalization regime was not without serious problems, however. These became apparent at the end of 1980. Most obvious was a worsening balance of trade, large trade deficits, a growing budget deficit, and an annual inflation that reached around 40 percent in 1981.

One may attribute the worsening macroeconomic environment of the early 1980s to a number of factors. They partially emanate from the need of the UNP government to employ deficit financing to support a series of public-sector investments initiated concurrently with liberalization. The largest was the capital-intensive Mahaweli River Development Program, with the free-trade zone, major housing and urban development projects, and water projects also demanding heavy public-sector investments. The result was that capital expenditures as a percent of total public expenditures increased rapidly from 24 percent in 1977 to 46 percent in 1982.

External events also significantly contributed to the difficulties encountered with the liberalization program in the early 1980s. Most important were the rise in oil prices and the dramatic deterioration in the terms of trade between 1980 and 1983 to levels that prevailed in 1975. These events adversely affected both foreign-exchange earnings and the budget deficit through the fall in export revenues and revenue from export duties.

As a result of growing deficits and inflation, austerity efforts continued after the election in 1983, both in terms of budget cuts and devaluation. Furthermore, a quick examination of the foreign financial assistance contributing to the net cash deficit makes it clear that continued support of international institutions was a critical prerequisite to Sri Lanka's ambitious investment program.

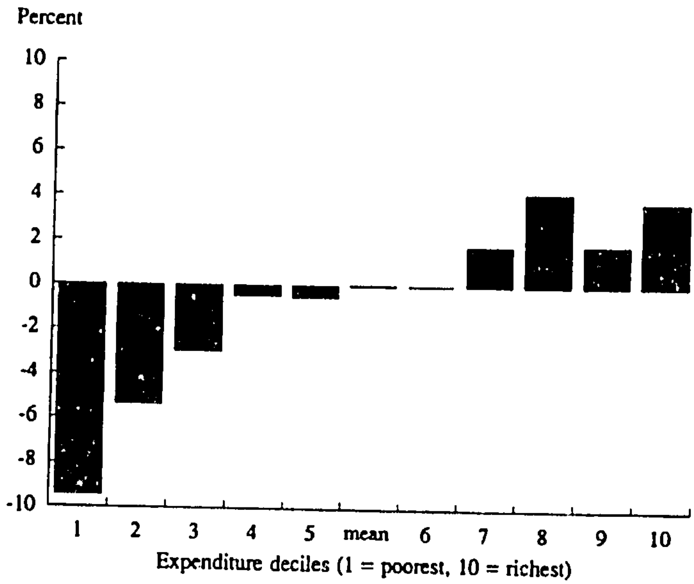
These questions of macroperformance are dealt with extensively in other reports (Central Bank of Ceylon, various years). Similarly, the microimplications of the policy reforms are addressed in greater detail elsewhere (Sahn 1986). However, there is evidence that the government expected that a combination of reduced subsidies, rapid food-price inflation, and decontrol of prices would be accompanied by a deterioration in the equitability of income distribution in Sri Lanka. This is supported by the Central Bank of Ceylon (1981):

> Income inequality tends to widen in the initial stage of economic growth as richer groups increase their incomes at a faster rate than the lower income groups. Given the economic reforms of 1977 and the massive increase in the investment after that date, it is likely that the trend in the distribution of income will be initially adverse; the economic benefits of major economic reforms do not percolate down to the lower income groups in such a short period.

This, coupled with indications that major price increases of staple food commodities, especially rice, would result in a net loss of income for small farmers, landless laborers, and urban poor, supported the view that despite an improved macroeconomic climate, there might indeed be short-term losers from policy reforms initiated in the late 1970s (Sahn 1987). In reality, the real expenditures of the poorest quartile of the expenditure distribution did decline (Edirisinghe 1985; Sahn 1987). The consumption consequences reflected these changes—the calorie consumption of those in the lowest expenditure deciles dropped between 1978–79 and 1981–82, while intake increased for those in the upper expenditure groups (see figure 3.1).

Recognition of the problems accompanying liberalization revitalized the debate on equity versus growth in Sri Lanka. The long-standing commitment of the political process to provide for the poor resulted in a reexamination of how

FIGURE 3.1 Percentage change in daily calories consumed per adult equivalent, by income decile: Sri Lanka, 1978–1979 to 1981–1982



SOURCE: Sahn 1987.

to achieve social goals without jeopardizing investment in physical capital. The government recognized research results that indicate that the real value of the income transfer in the form of food stamps declined and that there was considerable leakage of the food-stamp scheme to upper income groups (Edirisinghe 1985). In 1985, policy reforms were initiated to better target the program.

The revised scheme was to be administered by the Social Services Department instead of the Food Commissioners Department (Sri Lanka Department of Government Printing 1985). The change in the character of the program and the implementing agency was to ensure government determination to achieve efficient targeting of the income transfers. Basically, the new program aimed at redistributing the current outlay of the government transfer to those in the bottom quartile of income distribution. This was warranted because, as of 1982, this quartile received less than 40 percent of the total outlay.

Initial attempts to implement the new program were met with strong protests from both the current beneficiaries and their representatives in the legislature, resulting in a postponement of the implementation.

The goal of improving the efficiency and equitable nature of transfers, even if they were smaller in overall magnitude, is an illustration of Sri Lanka's ongoing concern with the indigent. The roots of these concerns are difficult to delineate. They partially emanate from the political power of the poor, as exerted through long-standing democratic traditions. In addition, the strong intellectual and academic tradition of social welfarism that exists in universities and other institutions in Sri Lanka undoubtedly influences government officials and policy makers, encouraging a concern for and awareness of the needs of the poor. This, coupled with the pride that accompanies the international acclaim received for basic human needs accomplishments, also perpetuated a sensitivity to the needy. This not only portends good things for the poor but for the nation as a whole. The political process reflects the needs of not only the well-to-do but those less prosperous as well.

Conclusions and Lessons

In analyzing the transition in Sri Lanka from what was primarily a welfare-oriented state to a liberalized economy where more emphasis is placed on the free market, a number of consistent themes emerge. Similarly, many issues remain unresolved and lend themselves to further research and analysis.

First, the controversy continues concerning the accomplishments of and returns to social expenditures during the 1960–1977 period. There is little doubt that more efficient operation of social welfare programs would have been feasible. However, one has to view with caution any assertion that diversion of welfare expenditures to investment would have been effective at generating significantly greater growth, especially considering the crucial role of exogenous events and international influence on the Sri Lankan economy. Similarly, the contribution of social welfare programs to economic growth and performance through human capital formation should not be overlooked. Nevertheless, the poor economic performance from 1970 to 1977 was primarily responsible for the election of a new government in 1977, giving it a mandate for the dramatic policy changes that were to occur.

Second, the success of the post-1977 economic reforms hinged fairly heavily on the moral and economic support of the free-enterprise-oriented donor community. In other words, the commitment to promotion of economic efficiency through the market system, rather than government intervention, brought about unprecedented external support. This aid was for investments that actually increased the role of government as an actor in the economy, at least in the short run. In this regard, a number of interesting lessons can be learned. It appears that the government's move toward liberalization by reducing consumer subsidies, decontrolling prices, and devaluing the currency was sufficient to garner support of donors and avoid the monetarist prescriptions that are traditionally associated with the IMF–World Bank structural adjustment programs. Simply, Sri Lanka succeeded in circumventing certain key components of structural adjustment and stabilization, as witnessed by the growth in borrowing and deficit financing that occurred in the postliberalization period. This raises the question as to whether the reduction or elimination of social

14

welfare expenditure was a sine qua non for the external support, despite the government's adoption of an expansionary fiscal policy in the wake of the shift toward a freer market.

Nevertheless, even in the face of pressures from international lending institutions to adhere to certain policies, the most important element that has steered the process of development in Sri Lanka has been the strength of the participatory democracy.

A third consideration is the extent to which the postliberalization economic surge was partially made possible by the extensive investments in human capital that preceded the shift in government priorities. One could hypothesize that in the absence of a relatively educated and healthy population, the effects of the liberalization experience would have been less favorable. On the other hand, one can query why the extensive subsidies and expenditures on human capital development did not fuel rapid economic growth before the policy changes in the late 1970s. Government intervention, mainly in the arena of basic human needs, may be an appropriate prelude to a more laissez-faire approach designed to allow the free market to allocate resources most efficiently.

Fourth, the rather successful and peaceful transition from basic-human-needs-oriented development policies to a free-market economy in Sri Lanka represents a lesson for other nations. There were many periods in Sri Lanka's history in which removal of food subsidies was greeted by anger and violence. This was not the case in 1978. In determining why, a number of propositions arise. One important fact is the phased process in which food subsidies were reduced. Of equal prominence is that the transition took place concurrently with a surge of economic growth and optimism. Just as it has long been argued that social programs are more politically palatable in an expanding economy than in a contracting one, it may well hold that reducing subsidies is more acceptable when the economy is growing and all feel that they will benefit in the not-too-distant future from its continued vitality. This is juxtaposed with reducing food subsidies as part of overall austerity measures in periods of economic retrenchment.

Fifth, such economic policies as devaluation of the currency to promote exports and encourage free trade come into conflict with the large fiscal and foreign-exchange costs of food-subsidy programs. Of course, there are arguments that subsidies moderate wage demands and, thus, export goods may prove more competitive. In theory, lower wages due to subsidies may also promote increased demand for labor. There is, however, no empirical evidence that this theory was realized in the import-substitution economic environment of pre-1978 Sri Lanka, where rigid wage laws also existed.

Similarly, it is noteworthy that the magnitude of recurrent expenditures on food subsidies and other social investments found in Sri Lanka during the 1970s is often the subject of criticism by economists because of the potential link of such spending with budget deficits and, consequently, inflation. However, there is an irony in that the reduction of these expenditures was followed by a period of increased budget deficits, contributing to high levels of inflation. These problems can be attributed to a combination of the government's undertaking other types of investments, especially in the area of infrastructural development, and international shocks to the economy. Undoubtedly, the deficits and inflation would have been exacerbated if recurrent expenditures on transfers would have remained at the historical high levels of the mid-1970s. Nonetheless, it is apparent that even when such expenditures are greatly reduced, if fiscal restraint is not followed in other budget items, the precise macroeconomic problems to which social expenditures may contribute can arise in spite of their reduction. In such a circumstance, those most in need are hurt doubly by the reduction in the income transfers and the ensuing inflation due to international events and government policy in other sectors.

Finally, there are indications of the need for a country such as Sri Lanka to judiciously combine policies such as the promotion of food self-reliance with a liberalized trade regime. While the former is geared to reducing dependency on international markets, the latter tends to increase reliance on other nations. Successful management of such a delicate balance is required so that a disproportionate burden of adjustment does not fall on the indigent.

, 16