

# Changes on Income Inequality Trends Sri Lanka

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## Introduction

The shape of the income distribution in a country is subject to change with structural changes in output and employment. Since the mid 1950s, pioneering work done by Arthur Lewis, Ranis, Fei and others, has theoretically demonstrated this phenomenon by emphasizing the dualistic features in developing countries. According to their models, a rising share of the modern sector (mainly the manufacturing industry) in terms of output and employment makes income distribution more unequal in the early stages of economic development. That is because before the Lewisian turning point occurs, labour income remains unchanged while profit income rises in the modern sector. Therefore, income distribution in developing countries can theoretically have a long term equitable shape only after the absorption of surplus labour working in the backward agriculture

On the other hand, following Kuznets (1955), Oshima (1962), Mizoguchi (1985), many studies have empirically shown that the rising income inequality in the early stage of economic development is due to changes in employment and output structure, and is influenced by factors such as population growth rate, savings and investment rates, education expansion, technological progress, migration, urbanization, etc. Therefore, some studies have suggested government intervention as a way to generate equitable growth in developing countries. For example, Fei et al. (1978) have empirically shown that the

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rural agricultural-oriented growth in Taiwan led to the neutralization of the Kuznets effect in the early stage of rapid economic growth. As a result, Taiwan could achieve both equity and growth objectives simultaneously. Furthermore, Ikemoto (1991, p. 14-19), argues that the rural development policies and the minimum wage laws were favorable for the falling income inequality in Thailand in the early 1970s.

In addition, following Sen (1981), many studies have shown Sri Lanka as a country that achieved low income inequality and high social welfare indices in the early 1970s. The strategy used by Sri Lanka differed from other Asian countries in putting more emphasis on welfare improvements rather than balancing growth and equity objectives. According to others, the equity and welfare oriented development policies of Sri Lanka after the independence were greatly influenced by the great depression, the malaria epidemic, World War II, the Korean War, Theravada Buddhism, British welfarism, the satisfaction of the requirements of Indian government regarding living standards of Indian immigrant workers in estate plantation agriculture etc. (see Bruton (1992), and Oshima (1987), for analytical presentations on these causes). However, due to the slow economic growth, growing labor force participation, high unemployment, and balance of payment constraints, in the mid 1970s the country could not continue with these policies. Therefore, it introduced growth-oriented liberalized economic policies in 1977. Although Sri Lanka could double its output growth by implementing these policies in the short term, inequality in the distribution of income increased during the 1973-1987 period. However, according to the latest (1996/97, issued in 1999) Report on Consumer Finances and Socio-Economic Survey, both equity and growth performance are in a better position in the 1990s. One of the important factors behind the declining income inequality trend is the change in industrial structure in terms of output and employment. However, to the best of the author's knowledge, there is no single empirical work regarding these issues in Sri Lanka. Therefore, this paper, attempts to empirically relate industrial structural changes to the income inequality trends in Sri Lanka during the last four decades.

This paper is organized into seven sections. After the introduction, the methods of analysis are explained in section I. Section II describes data, definitions and the limitations of the paper. Section III highlights overall trends in structural changes of output and employment. Section IV outlines the overall trends of income inequality in Sri Lanka. Section V decomposes and disaggregates total income inequality by industries. The main findings are summarized in section VI, the last section.