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ECONOMIC GROWTH, POVERTY AND INEQUALITY: UPDATE ON THE DISCOURSE AND LESSONS FOR SRI LANKA

N Herath[1] and G Herath[2]

Abstract

The interplay between economic growth, inequality, and poverty underscores the complexity of development dynamics and the challenge of alleviating poverty. Economic growth is necessary for poverty reduction; however, its adequacy is an issue that has been discussed for about 7 decades. Emphasis on growth promoting policies for reducing poverty fluctuated from time to time depending on the empirical findings. Availability of reliable data and improved computing facilities enabled quantifying the relationship between economic growth and poverty reduction. Many studies in the last decade of the 20th century and first decade of the 21st century confirmed that growth reduced poverty but effect of growth on poverty is heterogenous, hence supplementary policies are necessary to enhance growth effect on poverty. Moreover, the increasing inequality dampen the effect of growth on poverty. Sri Lanka is currently experiencing a crisis driven poverty and achieving higher rate of economic growth is critical for reducing wide-spread poverty.

Keywords: Economic growth; Inequality; Poverty; Sri Lanka

[1] Lecturer, University of Winnipeg, Manitoba, Canada
Email: nisal.herath@gmail.com
[2] Executive Director, Center for Poverty Analysis, Colombo, Sri Lanka
Email: hg309062@gmail.com

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Introduction

Sri Lanka showed a remarkable success in reducing poverty; the poverty rate declined from 23% in 2002 to about 4% by 2016. Macroeconomic mismanagement in terms of maintaining unsustainable budget deficit, insufficient tax collection indicated by declining tax to GDP ratio, lack of export promotion and more inward-looking economic policies, maintaining a negative current account balance, and filling the deficits using borrowed resource led to a collapse of the economy by 2022. Restrictive trade regime, poor economic institutions and governance and corruption issues also significantly contributed to the collapse. The government suspended debt servicing on April 12th 2022. People experienced unprecedented hardships due to shortage of fuel, food, medicine, and other essential goods. Economic growth was negative since 2019 (except for 2021); in 2022, it was -7.8% and -3.8% in 2023. COVID-19 also contributed to the present economic crisis. However, long term imbalances would have eventually led to a similar crisis sooner or later.

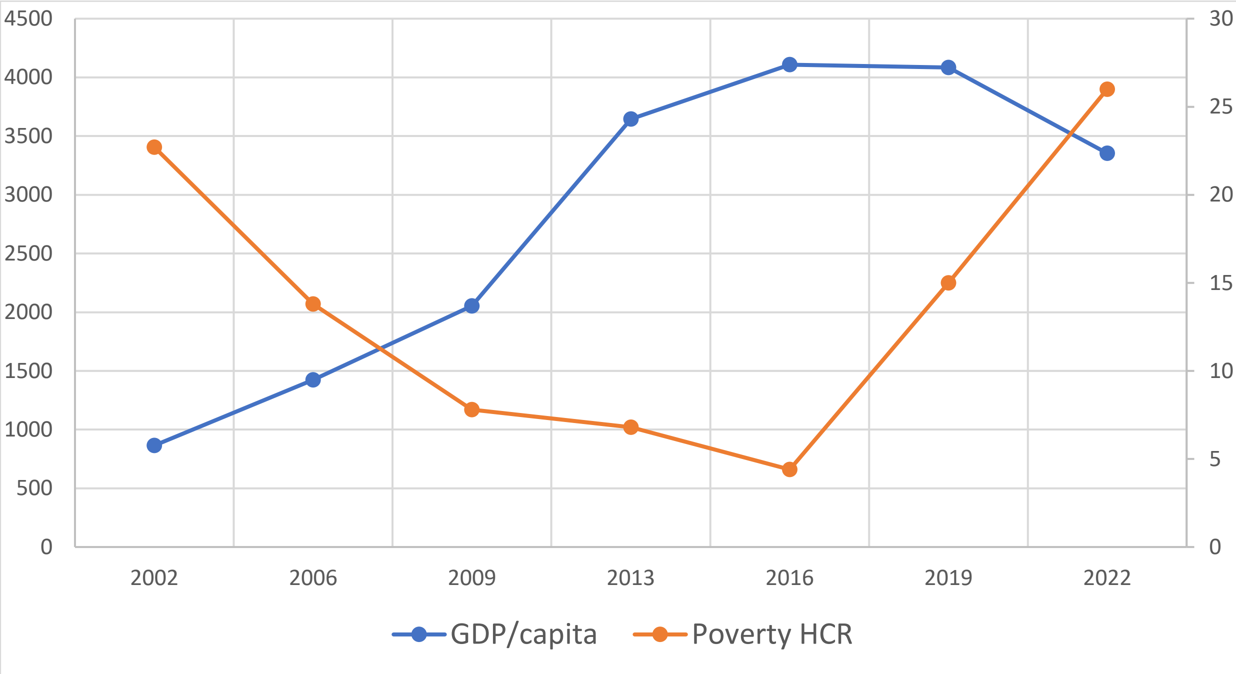

Figure 1: Per Capita Economic Growth and Poverty in Sri Lanka

Government signed an extended fund facility agreement with the International Monetary Fund (IMF) on March 20th 2023 and initiated a reform program under the guidance of the IMF. By the end of 2023, economy showed initial signs of recovery. Fourth quarter of 2023 reported small positive economic growth. Although inflation declined, hikes in food prices in December - January, 2023/24 indicates vulnerability. Exchange rate had also stabilized with an increase in reserves. Although these positive developments are encouraging, a lot more hardships can be expected for Sri Lanka as it may take another 3-5 years for the country to get back to the economic status it previously enjoyed in 2019. Once the debt moratorium is over, Sri Laka will face another wave of hardship as external debt servicing requires approximately $5-5.5 billion per annum.

As shown in Figure 1, lower or negative per capita economic growth has eroded the gains in poverty reduction in Sri Lanka. Supporting about one third of the population who live below poverty line by a bankrupt country is an enormous economic burden, on the one hand. On the other hand, failing to provide the basic needs to the impoverished population would be inhumane, and socio-economic and political fallout of ignoring the poor would be disastrous. The current economic environment demands the need to get back to a path of higher economic growth, amongst many other things. As well known, there is no linear relationship between economic growth and poverty reduction. In this context, it is opportune to revisit the economic growth, poverty and inequality discourse to shed light on the prospect of poverty reduction in Sri Lanka in the post economic recovery period.

The relationship between economic growth and poverty has been a topic of interest of scholars even in ancient Greece, Rome, India, Egypt and Babylon (Škare & Družeta 2016). In the recent history, economists began examining and formalizing the relationship between economic growth and poverty in the 1940s and 1950s. Subsequently, inequality gained prominence in the discussions on the relationship between economic growth and poverty. Economic growth measured by Gross Domestic Product (GDP) per capita, was widely seen as a reasonable measure of living standards. However, the relationship amongst economic growth, poverty, and inequality is complex and multifaceted. Economic growth can contribute to poverty reduction, but its benefits are not always distributed evenly across society. Moreover, poverty and inequality are closely intertwined as inequality can contribute to the perpetuation of poverty through barriers to accessing education, healthcare, employment, and other opportunities. Conversely, poverty can also contribute to increased inequality. Therefore, effective policies to address poverty and inequality require a holistic approach that considers the underlying social, political, and economic factors shaping dynamics of growth and poverty.

This paper reviews the literature on economic growth, poverty an inequality. It is organized as follows: Section 2 reviews the trickle-down effect related theories from the 1950s and 1960s; Section 3 surveys what the data revealed on growth and poverty reduction; Section 4 examines how economic growth reduces poverty; Section 5 explores growth elasticity of Poverty; Section 6 provides lessons for Sri Lanka and Section 7 presents the conclusions.

The Trickle-Down Effect: Economic Theories in 1950s and 1960s

Many of the economic theories in the 1950s and 1960s postulated that the benefits of economic growth would trickle down to reduce poverty. Of the many, stages of economic growth model by Rostow (1959) recognized that countries pass through distinct stages of economic development on the path to prosperity. In the first stage of a traditional society, the economy is primarily based on traditional agriculture, characterized by subsistence farming, low investments and innovations, little technological progress, and poor infrastructure. Living standards are generally low, there is limited access to education and healthcare and usually poverty levels are high.

Rostow explained that when countries invest in roads, telecommunications, and electricity and water utilities in conjunction with development in education and healthcare, which increases human capital development, it will transform their societies to more productive ones. Parallel developments in economic institutions in terms of legal frameworks and governance structures support economic development and contribute to a gradual rise in living standards. There is a take-off moment where a society transitions from a traditional agriculture-based economy to one with an industrialized economy. This take-off is characterized by increases in domestic and foreign investment, rapid development in manufacturing and industries, increased productivity and technological advancements and innovations, which result in further economic growth. This phase also sees infrastructure improvements, financial systems development, improvements in education and healthcare, and improvements in economic institutions.

The drive to maturity is the next stage. As the economy diversifies, there is more diverse employment, increased wages, and there is also the potential for a continued reduction in poverty rates as wealth is distributed more widely across various sectors. The final stage is the age of high mass consumption. In the final stage, development shifts towards enhancing the quality of life including access to infrastructure, education, financial systems, and social safety nets. Economic institutions are mature to ensure and sustainability of growth and development. Living standards reach their peak as the economy achieves a high level of affluence and therefore poverty should be minimum. The Rostow model assumes that all countries would eventually become developed following the above-described process. This process would be homogenous for all countries and eventually it will reduce poverty. The trickle-down theory suggests that policies that lead to economic growth will ultimately lead to poverty reduction (Arndt 1983).

Kuznet's (1955) inverted U shaped relationship between growth and inequality was in harmony with Rostow's (1959) stage of development theory. Kuznet (1955) hypothesized that as economic growth initially leads to an increase in inequality due to uneven distribution of economic outcomes and unequal access to education, employment, resources and opportunities. As the development process continues, inequality peaks until it reaches the tipping point. After the tipping point, further economic development leads to a reduction in inequality due to greater distribution of the benefits of development and better access to education, employment, resources and opportunities. However, as we show in this paper, literature has mixed views of the claims of Kuznets hypothesis (Kuznets 1955).

Simpson (1949) asserts that neoclassical economic model, which relies on markets to allocate resource in the economy, is capable of reducing poverty. He acknowledges the role of factor markets, such as labor markets, in determining income distribution and consider economic growth as a key driver of poverty reduction. Policies that promote efficient functioning of these markets such as reducing barriers to entry and improving labor market flexibility contribute to overall economic welfare and potentially reduce poverty. Persistence of poverty in developing countries is due to market failures such as market power and information asymmetry. Government policies such as social safety nets, targeted interventions, and regulatory measures, are crucial for addressing market failures, which reduces the ability of the markets to reduce poverty.

Dual economy was another well-known economic model of growth and poverty reduction (Lewis 1954). Lewis's dual economic model divides the economy into two sectors: the traditional agricultural sector and the modern industrial sector. The economy undergoes structural transformation as resources shift from agriculture to industry and this process of industrialization and structural transformation contributes to sustained, economic growth. The model suggested that targeted interventions to shift surplus labor from low-productivity traditional sectors to high-productivity modern sectors could lead to growth and poverty reduction. Another popular development model was the Harrod-Domar Model (Eisner 1952). This model also implied that policies encouraging higher levels of investment could contribute to economic growth and reduce poverty. Although not explicit, Simpson's (1949), Lewis' (1954) and Harrod-Domar's (Eisner (1952)) theories too assumed trickle-down effect.

Even at the early stages of the development of the theory on growth and poverty there was no consensus. For example, Kaldor (1956) challenged the trickle-down effect. The neoclassical approach relied on marginal productivity theory, in which each factor of production is rewarded according to its marginal contribution to output. Instead, Kaldor argued that the distribution of income is determined by the relative shares of profits and wages, and these shares are influenced by factors such as the degree of monopoly power, the distribution of income between different sectors, and the bargaining power of labor. Kaldor (1966) added that the distribution of income is not solely determined by marginal productivity but is influenced by broader macroeconomic factors. He highlighted the importance of the overall distribution of income, rather than individual factor productivity which gives a better understanding about the relationship between economic growth, poverty and inequality.

Structuralism, proposed by Arndt (1985), focuses on the underlying structures of an economy such as institutions and markets. A component of this model is the dependency theory where underdevelopment in certain countries is a result of their dependency on more developed nations. Arguing that the international economic system tends to benefit the developed countries, and this accounts for differences in poverty across different countries. Therefore, structuralist policies often advocate for import substitution, which involves promoting domestic industries by substituting imports with domestically produced goods and a strong role of the state in economic planning and intervention to address social and economic inequalities. Many former colonies of the West implemented import substitution policies soon after their independence. However, these policies led to protectionist practices, inefficiencies, and a lack of emphasis on market-oriented reforms which did not lead to economic growth and poverty reduction as experienced by many developing countries in 60s, and 70s. The Sri Lankan experience from 1970-77 is a good example of import substitution and poor overall economic performance.

Becker (1962) and Schultz (1961) conceptualized human capital theory, which highlighted the role of education and health in enhancing the skills and productivity of the workforce. The returns to human capital are that individuals who invest in their education and skills are likely to experience higher productivity, increased income, and improved employment opportunities. Higher levels of education and skills are generally associated with higher lifetime earnings. Differences in human capital accumulation among individuals or groups can contribute to disparities in income and economic outcomes. Therefore, incentivizing and supporting investments in human capital will promote economic growth and reduce poverty and inequality. Becker (1962) and Schultz (1961) pointed out that the effect of growth on poverty can be enhanced by focusing on human capital formation. Later this concept was better elaborated as "inclusive growth". Another important concept which came into the literature later was the growth diagnostics (Hausmann et al. 2008). The primary focus of growth diagnostics is on identifying the most significant constraints or obstacles that hinder economic growth such as poor infrastructure, education, institutions, regulatory environment, access to finance, and macroeconomic instability, and propose interventions to remove the said binding constraints.

Growth and Poverty Reduction: What Did the Data Reveal?

One of the influential studies by Chenery et al. (1974) highlights that the average per capita income of the third world has increased by fifty percent in about 20 years without significant benefits to the poor. This study uses the dualistic development framework, rather than the structuralist approach more typically used previously. It explored the relationship between economic growth and income distribution, focusing on achieving both economic growth and a more equitable distribution of income simultaneously. While casting doubts about the trickle-down effect, this work asserts that growth and redistribution are not necessarily conflicting goals and therefore policies could be designed to promote both higher economic growth and a fairer distribution of income. There should be a great emphasis on investments in human capital through health and education to promote income distribution. Other studies such as Thornton et al. (1978) and Korzeniewicz and Smith (2000), have provided empirical evidence against the trickle-down effect. Studies such as Arndt (1983) and Stigilitz (2015), and Greenwood and Holt (2010) show theoretical evidence against the trickle-down effect.

The above findings doubting the trickle-down effect had significant influence on the development policies. Major donor agencies like World Bank and most of the regional development banks like Asian

Development Bank (ADB) shifted their emphasis from economic growth to targeted poverty reduction measures. Many development financing agencies declared poverty reduction as the goal of these organizations. Assessment of poverty impact of investments were made mandatory and poverty reduction specialists were recruited in large numbers to ensure investments were directly linked to poverty reduction. In essence, these measures reflected that there were doubts about ability of economic growth to reduce poverty without supplementary policies.

Improvement of data collection in developing countries and computing facilities enabled testing the above cited theories on the trickle-down effect using rigorous econometric methods. One such early study by Dollar and Kraay (2001) showed that economic growth has a positive impact on reducing poverty. This study used 92 country panel data of four decades and various measures of poverty and income distribution. The study challenged the notion that the benefits of economic growth spurred by open trade or other macro policies primarily accrue to the rich, asserting that growth can be pro-poor. It showed that growth benefits the poor as much as it does the typical households, so that the growth-enhancing policies of good rule of law, fiscal discipline, and openness to international trade should be at the center of successful poverty reduction strategie***s.*** This study also showed that growth of income of the poor households does not appear to respond systematically to supposedly pro-poor policies including formal democratic institutions and public expenditure on health and education.

A series of other studies shows similar empirical evidence on the positive impact of the economic growth on poverty reduction. Ravallion and Chen (1997) estimated that 1 percent increase in per capita income led to a 3.1 percent reduction of poverty, using a 62 country data set and $1 per day poverty line. A similar conclusion was reached by Gallup, et al. (1999), Roemer and Gugerty (1997), Deininger and Squire (1996). This set of studies had a major influence in the approach to reducing poverty in early part of the 21st century. The policies that promote growth became the main focus in poverty reduction and the emphasis on the targeted interventions on poverty reduction waned away for some time.

All the above studies were published around the year 2000. Research on economic growth and poverty continued. Škare & Družeta (2016) reviewed 19 studies conducted since 1979 and reports that empirical findings confirm that economic growth reduces poverty in 17 studies. A similar conclusion was arrived to by Fosu (2010), and Newhouse and Vyas (2019).

How Does Economic Growth Reduce Poverty?

Economists continued to put more efforts to understand the crucial role of economic growth in reducing poverty. Economic growth typically leads to an increase in overall income levels in a country and directly contributes to reducing poverty by providing individuals and families with the financial resources needed to meet their basic needs (Klasen 2008). As Roemer and Gugerty (1997) showed, growth is associated with income generation, job creation, government revenue, human capital development, entrepreneurship and innovation, and access to infrastructure and services. The creation of new industries results in more job opportunities for the workforce and an environment conducive to entrepreneurship and innovation (Hull 2009). Employment is a key factor in poverty reduction, as it provides individuals with a stable source of income for the family.

Economic growth can also boost government revenue through increased tax collections (Agrawal 2007). Governments can use these additional funds to invest in social programs, infrastructure, and education and health, which are crucial components in the fight against poverty. Well-targeted government spending can directly benefit the poor through improved public services and social safety nets (Vetterlein 2007). Improved infrastructure can reduce the cost of doing business and make it easier for people in remote areas to access markets and services. Investments in education and healthcare helps create a well-educated and healthy workforce that is more productive and better equipped to participate in and contribute to economic activities which reduces poverty (Gupta and Mitra 2004). A growing economy requires more labor which leads to increased employment and household income reducing poverty.

Income generation, access to credit and financial inclusion, human capital development, infrastructure development, social safety nets, inclusive institutions and governance and reduction of income inequality are critical for poverty reduction (Cerra et al. 2021) Economic growth can lead to the development of financial institutions and systems, providing individuals with greater access to credit and financial services. Access to credit enables entrepreneurship and income-generating activities which helps alleviate poverty. Economic growth also leads to increased investments in infrastructure which facilitates access to markets, reduces transportation costs, and enhances overall economic efficiency, benefiting individuals in both urban and rural areas and contributing to poverty reduction.

Inclusive institutions and governance create a conducive environment for reducing barriers to economic participation and competitiveness amongst firms, forcing them to innovate and reduce costs. Technological advances enable firms to improve productivity and compete in the market. Universal, excludable and transferable property rights backed by proper enforcement not only encourage innovation but also ensure more equitable sharing of the benefits of economic growth. Thus, inclusive economic institutions are crucial for economic growth as well as fair distribution of economic outcomes (Gunatilake 2023).

Importance of physical infrastructure to sustain economic growth received more attention since the beginning of the 21st century. The relationship between economic growth, poverty reduction, and infrastructure is complex and interconnected (Timilsina 2020). Infrastructure which includes transportation, irrigation energy, water supply, and telecommunication, plays a crucial role in fostering economic development and improving the well-being of the population. Well-developed infrastructure improves overall productivity. It allows for the transport of goods and services more easily, reducing costs and enhancing efficiency. Increased productivity contributes to economic growth, thereby helping to alleviate poverty. Robust infrastructure systems can enhance resilience to economic shocks, natural disasters, and health crises.

Physical infrastructure is also vital for the delivery of services including education, healthcare, electricity and water. Improved access to services contributes to human capital development supporting economic growth and poverty reduction. Infrastructure projects that connect rural and urban areas can help bridge regional disparities. Enhanced connectivity promotes economic activities in both rural and urban settings which leads to more inclusive growth. Realization of the importance of physical infrastructure for growth led donor agencies to emphasize more investments on physical infrastructure.

Agriculture sector improvement was commonly assumed to reduce poverty, but agricultural growth may not necessarily be pro poor (Khan et al. 2014). While there was lots of evidence of growth's ability to reduce poverty, the magnitude of reduction in poverty has varied by country. Trickle-down theory must be supplemented by policies of inclusion that lessen sharp disparities in incomes and assets, enhance human capital accumulation and employment opportunities, and help provide safety nets for the more vulnerable elements of a society (Meier and Stiglitz (2001).

Growth Elasticity of Poverty (GEP)

Growth Elasticity of Poverty (GEP) allows a more formal examination of the relationship between economic growth and poverty reduction. It measures the percentage change in a target poverty variable due to a one percent economic growth. This strand of literature focuses on the analysis of household survey data to understand changes in income distribution and poverty levels. Ravallion and Chen (1997) used household survey data to analyze changes in income distribution over time for 62 countries. This study demonstrated that inequality reduces as often as it increases in growing economies. Using $1 per day poverty line, this study found that a 1 percent increase in per capita income led to a 3.1 percent reduction of poverty. Table 1 shows studies that reached similar conclusions. These studies trigger a policy shift towards growth-oriented policies as a means to reduce poverty. Global financial institutions shifted their emphasis from targeted interventions to more growth oriented interventions since first decade of the 21st century.

Table 1. GEP Studies

Study	GEP	Remarks
Newhouse and Vyas (2019)	-3.5 to -0.6	India household data for 2014-2015
Fosu (2010)	-5.8 to -1.3	Global sample of country data from 1980 - 2004
Gallup et al. (1999)	-4.2 to -2.8	Global sample of country data for 1995
Deininger and Squire (1998)	-0.71 to -0.01	Global sample of country data from 1960 - 1992

However, the belief that economic growth reduces poverty substantially didn't last long. New evidence showed that growth reduces poverty but the absolute impact is much smaller than those found in early studies. Ram (2011) confirms poverty reduction due to growth but claims that the absolute impact is much smaller than those found in early studies and Zaman and Khilji (2014) claim that growth is not always favorable for the poor. Fosu (2010) discusses heterogeneous impact of growth on poverty. East Asia and Pacific, particularly China, registered spectacular GDP growth per capita, resulting in substantial poverty reductions. However, South Asian countries, despite high GDP growth, have managed to reduce poverty in only relatively modest proportions. Furthermore, the moderate GDP growth in the Middle East and North Africa reduced poverty during the early periods, but the stronger growth in the latter period resulted in only modest poverty reduction. Thus, poverty impact of growth is not constant over time and vary from country to country.

Ravallion (2009) makes an insightful comparison of growth and poverty reduction experiences in Brazil, China and India. These countries have experienced poverty reduction in their reform periods, but to varying degrees and for different reasons. History left China with favorable initial conditions; there were larger distortions and low inequality for rapid poverty reduction through market-led economic growth. Prior inequalities and various other reasons handicapped poverty reduction in both Brazil and India. Brazil's success in complementing market-oriented reforms with progressive social policies has helped it achieve more rapid poverty reduction than in India, although Brazil has been less successful in terms of economic growth. Ravallion (2009) suggested that India may need to do more to assure inclusiveness. This analysis shows that initial inequality and size of the distortions in the economy matters in poverty reduction and better poverty reduction can be achieved from growth, if supplementary social policies of inclusiveness are implemented simultaneously (Ravallion, 2011).

The above cited observations highlighted the importance of initial inequality as well as the level of inequality that determines the effect of growth on poverty. In order to delve further into growth, inequality and poverty, let's have a more closer look at GEP. As shown in the equation, GEP can be decomposed into two components (Pernia and Kakwani, 2000)

$GEP = O_g + O_I$ (Equation 1)
Og = Poverty impact with distribution neutrality
O_I = the change in poverty when inequality changes in the absence of growth

O_g is the percentage change in poverty expected from 1% growth under the assumption distribution neutrality. This is also known as the Kakwani Elasticity (Ravallion, 2022), which is always negative, because positive growth always reduces poverty. O_I is the change in poverty attributable to changes in inequality. O_I can be either negative or positive depending on whether growth is accompanied by improving or worsening inequality. Poverty measurement is also important as growth elasticity of poverty varies across countries and depend on measurement of poverty (Bourguignon 2003; Bourguignon 2004; Fosu 2010). Kakwani (1993) derived a formula to estimate O_g which only requires actual poverty measures; no parametric forms or distributional assumptions about error terms and so on are required. This analytical elegance made it convenient to assess the effect of growth on poverty despite the realized GEP depends on change in inequality.

Ravallion (2022) reported Kakwani elasticities for individual countries (Table 2) as well as estimated them for regions. His regional estimates show that Kakwani elasticity rises as the poverty measure decline over time. Ravallioan (2022) makes the following observation about Kakwani elasticities: the Kakwani elasticities should not be thought of as "structural parameters" for a given country or region, as they vary over time; if growth is distribution neutral on average, then the higher the initial level of inequality, the lower the share of the gains from growth that will go to poor people; the fairly weak overall correlation between growth rates and changes in inequality naturally implies that absolute poverty measures will tend to fall with growth; and growth elasticities of rural poverty reduction are so much higher in China than India because inequality in access to agricultural land is much lower in China

Table 2. Kakwani Elasticities for Select Countries

Country (year)	Kakwani Elasticity	
	Headcount Index	Watts Index
Ivory Coast (2015)	-1.8	-2.1
Ethopia (2015)	-2.2	-2.6
Guatamala (2014)	-2.8	-2.5
India (2011/12)	-3.2	-4.0
Nigeria (2019)	-1.6	-2.3
Zimbabwe	-1.3	-2.2
Mean =-2, Ravallion (2022)		

Inequality in income distribution among the poor can increase poverty despite good growth prospects (Salvatore 2004). Piketty (2014) highlighted the long-term trend of rising income and wealth inequality. Inequality can negatively impact the growth of income of poor countries and positively impact the income growth of the rich (Barro 1999; Barro 2000; Milanovic and van der Weide 2014). Capital has a major role in perpetuating inequality. If the rate of return on capital exceeds the rate of economic growth, wealth tends to become increasingly concentrated in the hands of a few. Policy responses including progressive taxation, wealth redistribution, and greater transparency in financial markets address inequality and greater economic equality and social mobility. More equitable distribution of resources and opportunities can lift people out of poverty.

Ravallion (2022) illustrates the growth, poverty and inequality relation taking Indonesia as a case study. Indonesia, has seen its $1.90 a day poverty rate fall from 69% in 1984, to 35% in 2000, and 6% in 2015. Across these same three years, the Kakwani growth elasticity (absolute value) for the Watts index rose appreciably, from -1.9 in 1984 to -3.7 in 2000 and -5.5 in 2015. Thus, Indonesia had the potential for an "acceleration" out of absolute poverty, whereby the same growth rate can achieve larger proportionate declines in the poverty measure over time as long as the growth process did not come with rising inequality. However, Indonesia experienced rising inequality since around 2000. Over the 30-year period, the Gini index for Indonesia initially fell (from 0.324 in 1984 to 0.286 in 2000) but then rose appreciably, to 0.397 in 2015. The rising inequality in the post-2000 period naturally slowed the acceleration, though a substantial reduction in absolute poverty measures was still evident.

Economic reforms that strengthen the market-oriented resource allocation also play an important role in deciding the magnitude of growth and poverty reduction. India provides a classic example of the impact of reforms. In India, up to mid-1970, progress against poverty was negligible with low growth and low GEP. Pace of poverty reduction accelerated in the post reform period despite growing inequality; higher growth as well as higher Kakwani elasticities helped. A key finding is that the relationship to the pattern of growth changed greatly, suggesting stronger intersectoral linkages, with urban consumption growth benefiting both the rural and urban poor. In contrast to the pre-reform period, growth in primary, secondary and tertiary sector outputs yielded similar impacts on poverty (Datt et.al, 2016).

The Lessons for Sri Lanka

The economic crisis crippled the economy for a while and then Sri Lanka entered into a $3. billion Extended Fund Facility (EFF) with the IMF, aimed at restoring macroeconomic stability, strengthening public finances, and promoting inclusive growth. Table 3 shows Sri Lankan economic indicators before and during the crisis as well as projections for the future. Under the IMF program, Sri Lanka implemented a series of policy measures, including fiscal consolidation, monetary tightening, exchange rate adjustments, and structural reforms to improve public financial management, enhance competitiveness, and attract foreign investment. These measures helped stabilize the economy, reduce inflation, and restore investor confidence to some extent in Sri Lanka's financial markets. One noteworthy aspect of the forecast in the Table 3 is that by the end of the IMF program Sri Lanka expects only a modest growth of 3%

Table 3. Sri Lankan Economic Indicators Around the Economic Crisis

	Pre-crisis year 2019	Year prior to EFF 2022	Year when EFF ends 2027
Per capita GDP (USD)	4082	3474	3720
Real GDP growth	-0.2	-8.7	3.1
Inflation (monthly average)	4.3	46.4	5.1
Primary budget balance (% of GDP)	-1.9	-3.8	2.3
Overall budget balance (% of GDP)	-7.5	-10.4	-4.5
Public debt (% of GDP)	89.0	128.1	104.4

Current account balance (% GDP)	-2.1	-1.9	-1.3
Gross official foreign reserves (SD million)	7,642	1,896	14,208
in import months	3.0	1.9	6.0
External debt (public and private) USD million	54.6	58.7	67.6
% of GDP	61.4	78.0	79.6
Source: IMF (2023)			

Negative growth experienced in 2019-20 and 2022-23 manifested in different ways to reduce welfare of the people. The very high inflation experienced in 2022 and 2023, higher taxes, job losses, and various austerity measures disproportionately impacted vulnerable populations and hindered social welfare initiatives. Social protection program, Aswasuma, was implemented without fully resolving the exclusion and inclusion errors, exacerbating the situation. There is growing evidence on the increasing hardships of the economic crisis on the population. The most recent survey undertaken by the Department of Census and Statistics (2023) shows that; about 60.5 % of households have decreased their household income; 91.0% of households experienced an increase in household expenditure; about 55% of the population is indebted and 22% of households are indebted due to economic crisis; of the 29% of the population with poor health 7% changed their health treatment procedure due to the economic crisis; and 54.9% of the student population has been negatively affected by the economic crisis.

Table 4 shows the GEP for Sri Lanka over time. Very low GEP between 2009 and 2016 is noticeable and perhaps unique to Sri Lanka. While this needs further investigation, the difficulty to reduce structural poverty when poverty levels are very low may be the reason for the lower GEP. The positive GEP between 2016-2019 is due to substantial increase in poverty while economy recorded a small positive growth.

Table4. Sri Lankan Poverty Indicators and GEP Over Time

Year	Headcount Index	Time Period	GEP
2002	22.7		
2006	13.8	2002-2006	-0.305
2009	7.8	2006-2009	-0.221
2013	6.8	2009-2013	-0.030
2016	4.3	2013-2016	-0.159
2019	15	2016-2019	1.244
2022	26	2019-2022	-1.235
A 5% Growth in GDP will Reduce Poverty HCR by about 6%			

The absolute value of GEP in the 2019-2022 period is fairly high for the Sri Lankan standards. Although GEP varies over time, similar GEP may prevail during the post crisis period. If such GEP is occurred, a 5% economic growth may reduce the poverty headcount ratio by about 6%. At 5% growth it will take about 10 years to reduce poverty from 31% to 18%. A sustained growth at a higher rate helps reduce poverty rapidly. As evident from the review on the growth-poverty relationship literature, as well as from the estimated GEP, it is obvious that getting back to a higher path of economic growth is of paramount importance to reverse the current trends and reduce the impact of the economic crisis on the vulnerable population. While growth is a must, inequality, which has a dampening impact on poverty reduction effect of growth, should be carefully watched. Inequality reducing supplementary policies should not be overlooked too.

Successful implementation of the IMF EFF will stabilize the economy and lay the foundation for a growing economy. However, the IMF program, though necessary, is not sufficient to ensure economic growth; a well thought out economic reform program is necessary to ensure growth. Fiscal discipline, augmenting government revenue, removing unjustifiable market interventions by the government, ensuring a level playing competitive economic environment, maintaining a free trade regime and promoting export-oriented industrialization, reducing the size of the government and reforming the state owned enterprises are some of the essential elements of the structural reforms necessary to spur growth. Better screening of public sector investment projects and minimizing corruption would be critical for the success of the reform program. Government has taken some initiatives towards this end but a lot more needs to be done to ensure that the country is transformed to a rapidly growing economy.

There are many shortcomings of the structural reform policies introduced so far. However, the scope of the paper does not permit a complete review of the already undertaken reforms. There are some imminent risks of failure of the reform program. First and foremost is the deviation from the reform agenda related to the upcoming elections. Signs of appeasement policies, which contradicts basic economic principles are being offered. Secondly, the policy process has so far followed a top-down approach without sufficient consultation and public participation. Transparency of the policy process is also low. This has resulted in low ownership of the reforms by the public and a growing anti-IMF rhetoric, and this also means risk of policy reversal is substantial. Third, is the implementation risk. Sri Lanka is known for abandoning reforms or partial implementation of the reforms. Abandoning 4 out of 16 previous IMF programs with partial implementation and deviating from the policy principle after completion of the programs is a case in point. Finally, the reform program so far had given scant regard for economic justice. This also has resulted in low ownership of the reform process by the public. As highlighted in the CEPA poverty symposium in 2023, how Sri Lanka will manage these risks will determine the future prospects of poverty reduction in the country

Conclusion

The interplay between economic growth, inequality, and poverty underscores the complexity of development dynamics and the challenges of achieving sustainable and inclusive prosperity. Economic growth is necessary for poverty reduction. However, its adequacy is an issue that has been discussed for about 7 decades. In the 1950s and 1960s, emphasis was on growth promoting policies assuming the trickle-down effect. Evidence in 1980s showed that growth may not necessarily reduce poverty. With the availability of reliable data and improved computing facilities, economists were able to test and quantify the effect of economic growth on poverty reduction. GEP estimations using multi-country panel data sets showed that economic growth does reduce poverty. At the on-set of the 21st century, emphasis was shifted again to growth promoting policies due to the influential studies which showed economic growth is pro-poor. Many studies in the first decade of the 21st century further confirmed that growth reduced poverty but these studies also showed that: effect of growth on poverty is heterogenous; GEP values are lower than those estimated around year 2000; high level of initial inequality and increase in inequality reduce the GEP; supplementary policies that promote inclusiveness, access to health and education, and access to physical infrastructure enhance the effect of growth on poverty reduction; and market oriented reforms enhances the prospects of growth as well as its effect on poverty reduction.

Sri Lanka is at a critical juncture in terms of its quest to become a developed country. Obvious mismanagement of the economy and reckless borrowing and wasting borrowed resources for consumption and low return projects together with poor governance and corruption had put the country 20 years behind. Sri Lanka just recorded a very small positive growth in the fourth quarter of 2023. Improving and sustaining the growth is of paramount importance for reducing poverty. Rectifying the shortcoming of the already introduced policies, implementing the reforms without deviating from them due to elections, paying attention to economic justice and improving on the consultative and participatory approaches in making as well as implementing policies should be given utmost importance if Sri Lanka is to come out of the crisis and move forward to a sustainable path of economic growth.

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