Chapter 1
Public Finance in Developing Countries: An Introduction

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ABSTRACT

After World War Two, when many countries became independent and the Bretton Woods institutions were created, economists and policymakers had statistical evidence of the enormous differences that existed, in the per capita incomes and in the standards of living, between rich and poor countries. Therefore, they became aware of the need for raising per capita incomes in the poor countries. Modern governments need revenue and often a lot more revenue than they needed in the past, in order to provide the levels of assistance and public services that modern societies expect governments to provide. It may seem to be desirable for governments to have more revenue to spend and leave the decisions, on how the extra revenue will be used, to a later time. However, this is not always the case.

INTRODUCTION

After World War Two, when many countries became independent and the Bretton Woods institutions were created, economists and policymakers had statistical evidence of the enormous differences that existed, in the per capita incomes and in the standards of living, between rich and poor countries. Therefore, they became aware of the need for raising per capita incomes in the poor countries. "Development economics", which had not existed before, was born as a special branch of economics and the search started for identifying *policies* that could make the economies of developing countries grow at fast paces, thus helping them to raise the standards of living of their populations. There was little controversy at that time that governments could play a major role in promoting economic growth. It was a time of great confidence in the ability of governments in solving economic problems. Public finance for developing countries became an important and special branch of "development economics" and of "public economics".

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A factor that immediately attracted much attention was "capital accumulation". Economists attributed the existing differences in the per capita incomes among countries to differences in the amount of capital that they had; and differences in growth rates to differences in the rates at which capital was accumulated. Rich countries were rich because they had more capital and faster growing countries were countries that were accumulating more capital. In one of his writings, in 1930, Keynes had anticipated this view when he had written that "[the] modern age opened… with the accumulation of capital… [and that growth had been driven by] … the power of accumulation [of capital] by compound interest" (p. 361). Keynes' view was later incorporated in the growth models that became popular and that went under the name of Harrod and Domar models. These models made "capital output" and "marginal capital output ratios" important statistics. Governments were encouraged to direct their policies toward the creation of capital and foreign aid to poor countries was directed toward the goal of capital accumulation.

THE ROLE OF PUBLIC FINANCE IN THE EARLY YEARS

The attention paid to capital accumulation led immediately to the role that taxation could play in this accumulation. Taxation came to be recognized as a powerful instrument that governments could use to promote the needed capital accumulation that would make the countries' economies grow at faster rates. The popular economic theories at that time, especially those associated with the so-called Harrod and Domar models, pointed to the role that taxation could play.

Capital accumulation could be public or private. Net *public* investment would contribute directly to capital accumulation and, by providing infrastructure needed for private activities, could also provide a stimulus to private investment. Private investment could also be encouraged by other government policies. The broad strategy that was recommended was the following: (a) The level of taxation had to be increased, to make more resources available to the government. (b) Government *current* spending had to be kept low so that the budget could generate a surplus (before accounting for the spending for public investment). The public surplus so generated would be used to increase public investments in *physical* infrastructure and to finance *public* enterprises. This was the strategy generally recommended at that time (from the 1940s until the early 1970s). For a clear and prominent example, see the recommendations of the famous Musgrave Mission to Colombia, in the early 1970s. The larger was the surplus generated, the greater would be the capital accumulation and the expected positive impact on economic growth.

At that time *current* public spending was not considered productive and there was resistance to the growth of public debt. In any case, in the absence of a global financial market, which later would make it easier for governments to obtain foreign loans, public borrowing could not have provided many resources to governments. Borrowing from central banks, in the form of what came to be called "inflationary finance", was associated with the printing of money and with inflation. When used, that policy created inflation and, when inflation became high, because of time lags in the payment of taxes, it reduced real tax revenue, due to what came to be called the *Tanzi effect* (see Tanzi, 1977 and 1978).

Private investment would be encouraged by the creation of the publicly- financed, physical infrastructure but it could also be stimulated by generous and well -targeted tax incentives. The protection provided to domestic enterprise by high import duties and by other import restrictions were also assumed to encourage private domestic investment. There was much faith at that time in the impact that tax incentives and policies of import substitutions could have on private investment.

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