

WHAT GOVERNMENTS SHOULD NEVER DO!

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❖ INTRODUCTION:

➤ The importance of von Haberler

Canada is a small, open economy. Since the Canada/US Free Trade Agreement in the late '80s and NAFTA in the early '90s, trade has become an even more dominant force in the Canadian economy. Trade accounts for about 40% of GDP. This is up from around 30% before the FTAs. And 70 to 75% of that trade is with one country. And this is down from 83%. So, Canada is increasingly dependent on trade and its trade is becoming more diversified by destination and source country (Foreign Affairs, Trade and Development Canada, 2013).

However, the composition of that trade is not changing significantly from what it was at the turn of the last century. While manufacturing is significantly more important than it was a hundred years ago, the trend is a return to dependence on commodities and raw materials.

In terms of Canadian economic development the Canadian economist Harold Adams Innis was key in positing and elaborating the staples theory where the exploitation of raw materials would guide economic development. And of course it was quite lucrative to be hewers of wood and drawers of water (Innis, 1941). But it was Haberler who promoted comparative advantage and the benefits of free trade. He suggested that there had been a decline in the terms of trade against commodities. But he would not allow that there would be an ongoing secular decline in the terms of trade for commodities and resources. Rather, he saw increasing scarcity overwhelming even technical innovation in bringing prices down (Haberler, 1936)

The structural changes in the Canadian economy from agriculture to other resources and from resources to manufacturing and then from manufacturing to services and back to resources have left us with a legacy of public policy that has favoured the sector of the day. The litany of subsidies and subventions that are testament to past successes has reduced the efficiency, adaptability and productivity of the Canadian economy. The market for our debt coupled with the forces of competitiveness based on trade have pushed us to abandon many of the historically inefficient policies (Lipsey, 2006).

For Canada, our recent past owes much to both Innis and Haberler.

➤ The lesson of Canada

In the late '80s and early '90s Canada was experiencing an increasingly important structural deficit. By the mid '90s, debt to GDP was running in excess of 70%. Debt service charges were running about a third of government revenues. When the Wall Street Journal called Canada a "first world banana republic" and the currency market went after the Mexican peso, Canada faced both a fiscal and an economic crisis (Graves, 2001).

The challenge for all governments is to take action BEFORE the crisis forces action. The then Deputy Minister of Finance, David Dodge, who went on to be the Governor of our central bank said in the mid '90s: "When the pattern of the brickwork on the wall you are about to hit becomes clear, you take evasive action." The challenge is to take the action with enough time to recover and avoid the wall. In Canada's case that is exactly what we did.

Rahm Emanuel, Obama's first Chief of Staff, is famously attributed the notion that you should never let a good crisis go to waste. What he actually said was: "You never want a serious crisis to go to waste. What I mean by that is an opportunity to do things you could not do before." (Emanuel, 2008). Indeed, when Canada was forced to adapt to an impending fiscal and economic crisis in the mid '90s, it took the opportunity to clear out many of the legacy policies that were left over from the old economy and got out of some of the policies that its government should never have gotten itself into. Canadian politicians were forced to take the action they were otherwise unable to take (Martin 2012).

And the vicious circle of debt and deficit, inefficient and unproductive economy, became a virtuous circle of surplus and flexibility, and adaptation and productivity leading to Canada being the best performing G8 country during the Great Recession of 2008 and its aftermath.

Fiscal sovereignty and the discretion and ability for government to make choices comes from a stable equilibrium in fiscal and economic performance. That is the lesson of Canada.

➤ What governments SHOULD do, MIGHT do, and SHOULD NEVER do.

The rest of the paper is organized around a public economics basis of identifying the rationale for government intervention and focusing on those things that government should actually do. There are indeed many things for which the state has a clear role that no one else can undertake and that are necessary to promote the efficient allocation of resources in the economy and to meet other ends. Moreover, the paper will discuss instrument choice and the limits of instrumentation in accomplishing the objectives of the state.

The paper goes on to identify a large number of issues where the state may play a benign or even positive role in promoting efficiency and equity justifiable in some circumstances. Again, instruments will be identified that may help achieve the state's ends, but others where the inefficiencies overwhelm the prospect of success.

The residual of what states should do, and what they might do, are those things that governments should never do. These are both policies without justification as well as instruments that are so inefficient in accomplishing those ends that they should not be used.

The paper will conclude using the Canadian experience of the '90s to tease out some lessons of what government should or should never do.

➤ Organizing Principle

The organizing principle of the paper is that there are few absolutes in what governments should do, might do or should never do. Rather, it is a way of thinking. One should always bring a degree of scepticism to approaching the problem of whether governments should do something or not. Moreover, a degree of realism and discipline is required where circumstances may justify intervention for a period, but where it is not justified over the long term.

Where activities of what governments should do are identified, most often, circumstances for the justification will be required and private products possible over time. Where governments should not do something, once again circumstantial arguments and criteria will be required where it may be possible to justify governments providing such services.

There is little novel in this paper. Many of the references date to early in the last century. We know what rationales are required to justify government intervention and have known so for some time. The economics literature is replete with explanations of and justifications for government intervention to improve the functioning of markets. However, it is obvious that these justifications are often honoured in the breach.

The key point of this paper is that justification for what governments do is required. Few, if any, activities are justified *ipso facto*. Few, if any, activities should be forbidden in all circumstances. The vast majority of activities will fall into the middle category of what governments might do. Indeed, there may be some activities that, in some circumstances, should be undertaken by government. Similarly there may be some activities that, in some circumstances, should not be undertaken by government.

However, there are few activities that should always be done by government and similarly few activities that should really never be done by government. The key

point is that government interventions have to be justified on their merits and the likelihood of governments being adaptable and able to withdraw from these interventions as appropriate..

➤ Objectives

My students seem to have endless sets of objectives and justifications of state intervention. Many of them are indeed justified. Some are necessary. Others desirable. And others are purely in the mind of the proponent. I will use the traditional classical economic rationales to explain those things that governments should do. There is much overlap among the conceptions of what government should undertake and why. The following is not a comprehensive taxonomy nor is it a set of mutually exclusive rationales. Rather it is a presentation and identification of some of the legitimate justifications of the role of the state, the circumstantial justifications and the residual of the unjustified roles of government.

To be able to explain what governments should do one must first set out the objective function of the state. Permitting and promoting the growth of GDP is indeed a credible objective function for government. Promoting social welfare may also be a legitimate objective of the state in a democracy (Arrow, 1963).

For those who bridle at the notion that there may be collective objectives like social welfare, recently there has developed a growing set of intangible and difficult to measure objective functions with focus on well-being. This includes subjective well-being, social well-being and ultimately the holy grail of individual “happiness” (Helliwell, 2013).

As we have seen, the UN has taken the happiness agenda seriously with some scholarly economic analytic work on it. And the King of Bhutan has tried to make it an iconic element of his objectives for his country. The happiness agenda should be very appealing to libertarian analysts as it refocuses attention on individuals away from collectives. The only problem is the measurement of individual happiness is so dependent on relative measures and on imprecise surveys.

The other challenge in considering happiness, and for that matter, social well-being, is the problem of compensation. Pareto’s optimizations did not require compensation, only that compensation of losers by winners was possible. Going the next step and actually taxing winners and/or compensating losers alters incentives and distorts future decision making.

As we consider the disaggregated objective functions of different groups in society we improve our ability to identify winners and losers. And we make more

difficult the actual compensation and the aggregation of success. As we disaggregate across *inter alia* special interests, generations, sectors, urban/rural splits and regional interests we start to set up a problem for governments in their attempts to improve welfare of their populations. We start to show up winners and losers.

So, in considering whose well-being we are trying to maximize, we inevitably come up against the problems of either aggregating across different objective functions or measuring immeasurables. And this is complicated by the great difficulty in compensating losers in Pareto efficiency terms.

❖ WHAT GOVERNMENTS SHOULD DO

In considering the rationale for what governments ought to do we can consider two categories of justifications. They are political and moral rationales on the one hand and economic rationales on the other.

Among the **political** rationales we find some of the following.

➤ Security

There are clearly justifications for some elements of **security** as a rationale for government intervention. While some elements of security can be provided privately like private police and gated communities, the bulk of social interaction requires some modicum of security to the person and to the state to allow for markets to work (Olson 1965).

Increasingly we see two sides to the role of the state in protection. Typically we have seen protection by the state of individual liberty and safety as a primordial responsibility. The pre-Westphalian state always did have ducal protection. The Westphalian state has had to protect its integrity by protecting its borders. The efficient functioning of markets within and between states has relied upon the maintenance of security to allow for transactions. I do not mean legal rules, which I will deal with below, but rather the actual safety of actors in conducting their transactions. This is often provided by armies, police, the courts and the lawmakers. Although Liechtenstein is a country without an army, it does have a police force.

The growth of the second side of this security objective is becoming quite tendentious. It is increasingly the protection of actors from the state rather than by the state. So, the growth of privacy rights in democracies and oppressive regimes where the terror is brought by the state complicates the role of the government. Governments should provide the modicum of security needed to promote security of the person and market transactions. However, it is quite unclear how to balance the need of governments in protecting actors, conflicts with the needs to respect the citizens' rights to be protected from the state.

Of course, even security can, in some circumstances, be purchased as a private good. The public goodness of security is related to the externality of one person purchasing security and others benefiting. The collective good of security can, in some circumstances be better and less costly provided by the state. This does not preclude topping up with private security purchased in the market.

➤ Justice

There is another series of rationales related to **justice** as a justification for state intervention. Clearly efficiency of transactions and economic growth depend upon a clear and well functioning legal order. The Lockean rules of the game in transacting need to be clear, well founded and well enforced. Governments have a responsibility to assign property rights and to promote efficient exchange. Independence of the courts, coupled with wisdom in arbitration requires a quality bench that is apolitical and responsive to the political process of policy decision making.

In addition there are individual and collective demands for justice in the meting out of decisions in applying laws. In this context, justice goes to questions of fairness and equitable access to the courts and to the respect and deference the populace has towards the courts. Confidence in the justice process and system is a pre-requisite for efficiency in transactions. Moreover, this can be a legitimate justification for assuring the market by ensuring property rights and allowing individuals the fruits of their labour. In a Nozickian world, the state still has a role in ensuring the intergenerational justice of the start points (Nozick 1974).

Finally, justice can imply the equality of opportunity in all actors able to innovate, create and produce. The state can play a role in this by assuring access to low cost investments in human capital and the assurance of the efficient allocation of resources in the economy.

Among **economic** rationales we find some of the following based largely upon market failures:

➤ Externalities

Pure, universal **externalities** are rare. There are many externalities, but most often circumstances make them abatable. If we are to consider when governments should always do something we need to unpack the category of externalities.

Some of these externalities relate back to the problems of security and safety. Recently in Canada we had a classic Coaseian case of trains and fires to the neighbours' property. A train transporting flammable oil went off the track in a little village and dozens of people lost their life and there was extensive property

damage. It was clear in the post-mortem that there had been a legitimate role for government regulation to minimize the externality of safety, but it had not functioned.

The case of second hand smoke and smokers placing the burden of health effects on others and in state run medicare systems on all of society is another. There are sometimes clear rationales for legally enforcing the internalization of these costs (Pigou 1920).

Another is in Canada where we had seen the acidification of the Great Lakes as a result of American burning of high sulphur fuels in power generation resulting in acid rain. Through international agreement, restricted the sulphur emissions, reduced the SO₂ in the atmosphere and thus reduced acid rain and the lifeforms in the Great Lakes have returned to normal. This internalization of costs has been efficient and effective (Environment Canada 1991). I shall return to the issue of instrument choice later in this paper.

We know that reducing speed limits would reduce fatalities and morbidity on the highways and yet we choose to balance the saving of time for motorists with the lives of the accidental victims. There is a role for the state in making such judgments. There is no absolute in the determination of maximum speed limit.

Externalities may, in some circumstances, warrant internalization. And governments should internalize costs where they are justified.

➤ Enforcing Property Rights

Incentives for creation require the returns to creation to be appropriated by the creator. Copyright and Patent protection provide incentives for invention by providing the appropriability of such returns (Alchian 1973). Intellectual property law is a bargain. If the creator exposes his creation, then a period of exclusivity is provided by the state. If a creator appropriates by secrecy then disclosure is not forced, but the rights and their returns cannot be enforced either.

If markets are to work in efficiently allocating resources then property has to be excludable and appropriable. Sometimes these do not exist without the help of government creating and enforcing property rights. Pharmaceutical inventions and cultural works all have to be protected or there will be a suboptimal creation and innovation of such properties.

If the post-creation market allowed misappropriation of the benefits of the created product, there would be underinvestment in creative activity. Suboptimal invention would lead to suboptimal growth and development. Exactly how much protection is desirable is unclear. Enough to stimulate invention but not so much as to thwart reuse of and building upon the creation.

Government can play a key role in this by providing, once again, the legal system of appropriation. The right such system can be self enforcing. Creators can contest their rights in courts of equity without state intervention in enforcement beyond the provision of the arbitrator of the courts.

Thus government should enforce property rights. However, how long and how strong are matters of dispute, judgment and choice. Providing framework laws may be sufficient to allow for private enforcement rather than state enforcement. And the global optimum for all may be different than the local optimum for small, open economies.

➤ **Informational Asymmetry**

For many markets and products there has to be transparency and frequency to the transaction for information to be adequate for optimal transactions (Akerlof 1970). When transactions are irregular and non-repetitive (like the purchase of funeral services) there are asymmetries in the information available in the market that thwart efficient decision making. The vendor knows full well what is included and what the alternatives and costs are. The purchaser does not. There would be non-replicable significant transactions costs to equilibrating the information. The state may have a role in requiring legitimacy of information in the market.

For child care services, there are interesting questions of the adequacy of information availability for parents to make choices. Nanny cameras are ways of balancing this. Investment in research of services available is another. In the end, there is a justification for government assurance of the market in child care services by setting minimum standards for care (Spence 1973) to increase the level and quality of output and to minimize transactions costs.

➤ **Public Goods**

Along the lines of information as a good is information as a public good. It need not be excludable except for the costs of acquisition. In addressing the role of the state in the provision of non-excludable, zero marginal cost products there is a clear role for the state. Classic public goods like clean air and public roads are actually far scarcer than many people think. The publicness of these goods are often limited to their non-excludability or non-appropriation possibilities. They do not extend to their creation nor to their financing. Thus, while public buildings might house governments, governments do not need to be involved in constructing buildings or in their financing.

➤ **Free Riders**

Many such public goods, because of the inability to exclude, allow free riders. Free riders distort incentives for the optimal creation of public goods (Cornes

1986). Classically, creating public roadways has not allowed imposition of the costs of construction on the beneficiaries. Proxies for these allocations have included gas taxes the revenues of which may be then earmarked to road construction. However, while free riders have been a problem in road and river use from the beginning of time, modern technology has allowed for user charges and exclusion of non-paying clients so as to allow the market to work.

Once again, free riders may make some goods and services public, but changing technology may allow for exclusion, appropriation and charging to the point that they can become private goods once again. Consider BitTorrent and other download sites. It is possible to download musical and film properties at virtually zero marginal cost. However, it is now possible, through technology, to limit access and thus appropriate the rents from use and keep the returns to creation adequate. Free riders can often be excluded with appropriate adaptation.

➤ **Managing the Commons**

The so-called tragedy of the commons (Ostrom 1990) does not refer to Westminster parliamentary democracies, although in some countries their House of Commons has become a tragedy. Rather it refers to the inability to exclude from some products and the collective value of the benefits of joint exploitation. The fishery is the classic industry or the old English common pastureland the iconic examples.

Industries like the fishery as a common property resource present some particular challenges. Overfishing is the classic result of the commons left to over exploitation. However, even in this case, the changes in technology and institutional innovation have lead to possible solutions. The UN Convention on the Law of the Sea treaty allows for appropriation of the common property resource by individual states tied to their littoral and thus allows for optimal resource management (United Nations, 1982). So, UNCLOS provides for a UN based, collective management of the common property resources of the sea and the seabed. Thus governments should be able to manage their common property resources to avoid overexploitation.

While this is a legitimate role for the state, one still must justify government intervention to the extent that it is going to lead to legitimate action. Imagine assigning lake property rights to private landowners as a similar solution to the common property resource management problem. The role of the state in this case is only to allocate the property rights and not to go so far as to manage the resource itself. Internalizing the externalities may be sufficient.

❖ **WHAT GOVERNMENTS MIGHT DO**

➤ **Equity**

Within the context of justice noted above there are often objectives of **equity** articulated in political processes (Rawls 1971, 2005). This leads to demands for redistribution. By trying to achieve some measure of equity governments often create disincentives for creation. On the other hand, stability of social interaction and the security identified above may require a modicum of equity in distributional terms. Grossly inequitable societies can ultimately be disrupted by social upheaval and revolution. Thus governments might try to maintain an equitable access to higher education. They might want to tax and redistribute income in such a way as to preserve the incentives to create and innovate. But this is easier to say than to do. The advent of self-reporting income taxes has improved the efficacy of state finance for the purpose of maintaining minimum income levels that have promoted social stability and security.

➤ **Morality**

There are also **moral** goods that governments might try to control or promote (Buchanan 1988). In such cases, the control of prostitution and access to alcohol may be justified on purely moral grounds. But if we have learned anything about economic transactions in markets for immoral goods it is the gross inability to absolutely prohibit them. Governments can suppress their evidence and perhaps disincentivize their populace from participating, but there seems to always be a residual activity. In these cases, it is often preferable to regulate the offending product, good or service than to try to prohibit it.

Two recent examples in Canada have provoked great controversy. The Supreme Court of Canada has found that the prohibition of on street soliciting for prostitution has led to the physical endangerment of the prostitutes (Supreme Court of Canada, 2013). Their rights to security of the person were violated by the prohibition forcing them to unsafe sale of their services. The government has to find a new way to regulate prostitution rather than ban its exchange on the street. Another example has been the previous Québec government maintaining the secularity of the state by trying to ban the wearing of religious symbols by public servants (Québec, 2014). This would mean Jews could not wear a kippah, Sikhs could not wear a turban and Muslim women could not wear a hijab or niqab. In uniquely conflictual fashion it was allowed that Jesus on the cross in the legislature was manifestation of tradition and not religion. The government was defeated before it could enact the secular charter of values.

These attempts to legislate morality are fraught with challenges. However, using the right instruments, it may be possible to make them effective.

➤ **Culture**

Governments often try to **promote culture** in their societies. With increasing globalization and the hegemony of some dominant cultures, is it possible for a

small, open country to promote its unique culture? While I raise the question insofar as it applies to Canada, holding the conference in Liechtenstein makes the challenge even more stark (Audley 1983).

A values based focus on culture rather than a product based focus may help. But in the end any attempt to promote culture will inevitably improve the outcomes of some creators of culture and hurt others. By allocating property rights through copyright and trademark and other intellectual property rights legislation states promote the success of some but may or may not promote the uniqueness of the small state's culture. If we are to be non-discriminatory in the application of these rights, then the culturally hegemonic will dominate. So, Hollywood films will overwhelm Canadian.

Nevertheless, governments may find ways to promote cultural uniqueness without making the protection of intellectual property a transfer from its consumers to the foreign owners of these rights. Inducements to create based on a transient, interim protection or subvention may lead to an improvement in cultural creativity so long as it is not built in forever. The problem with such infant industry arguments, of course, is that it is very hard to declare success and dissolve the protections that have been introduced.

➤ **Macroeconomic Performance**

There remains much controversy over the ability of the state to “manage” macroeconomic performance. I would argue that the recent experience of the Great Recession has shown that measured, limited intervention in the case of systemic loss of confidence has promoted improved macroeconomic performance. Canada's expansionist fiscal policy during the recession and our rigorous banking regulation have lead to Canada's very successful economic performance from 2008 through the present (OECD 2012). If anyone had told Prime Minister Harper that he would preside the largest deficit in Canadian history, he would have said “Never”. However, even a Conservative, centre-right government had to respond to the circumstances. The expansionist monetary and fiscal policy kept aggregate demand up and confidence in financial markets. Canada is the only G7 or G8 country that did not experience significant declines in aggregate output and experienced no failures or needed bailouts of our financial institutions.

Once again, it is a circumstantial justification for government intervention driving macroeconomic performance. It is not necessary that government fiscal and monetary policy be driven to manage the economy.

➤ **Stabilization**

The example above of the 2008 recession demonstrates the possibility of government intervention stabilizing economic performance. However, the notion that all shocks can be smoothed out by government response is fallacious. It would require an all knowing government and omniscience is not something there is any evidence for in government. Thus in the right circumstances, there may be justification for stabilization policy. But in most cases, it is not so.

➤ Infant Industries

Infant industry is an oft heard justification for government intervention. However, the nature of the problem has to be specific and the time for support has to be limited. While this sounds simple it is almost always absent (Melitz 2005).

In Canada, facing the cultural hegemony of the US, we had protected some elements of the Canadian cultural industries. This had the effect of protecting the successful creators of cultural products and making them very rich. But that was not what it was intended to do. The successful were already successful. It also had the effect of protecting the unsuccessful producers of cultural products and this was not desired and represented a deadweight loss to Canadian economy and society.

Now it did have the effect of stimulating the development of a nascent cultural industry that would never have been able to survive in light of the lead and dominance of the US. Now that it has been successful it is time to abandon the protections but the industry is of course dependent upon the protection and the politics of removing the protection all work against doing the right thing.

It may be justified to protect an infant industry. However, it must be unprotected when it reaches adolescence.

➤ Principal/Agent problems

Often it is difficult to align the incentives of agents with their principals (Eisenhardt 1989). In such circumstances, there may be a role for government in assuring the market. Real estate agents must work for only one side of the bargain. But in some cases, there have been examples of agents working both sides of the exchange and ultimately working for themselves. Where individuals have trouble negotiating private arrangements with their agents in light of industry wide standards etc, then it may well be justified for government to set rules of the game for principal and agent transactions.

Similarly, in financial transactions, the agents may not have their objectives aligned with the principal they serve. In this case, there may well be a role for government to assure the market. In each such case, the role of government is not to supplant the agent and undertake activities for the principal, but rather to set rules by which the transactions can take place through the market.

➤ Market Power

Where barriers to entry are high and markets may suffer from not being easily contestable, governments may have a role to play in limiting the private sector's market power, breaking down barriers, or promoting competition (Posner 2007). Where a company has such market power, the appropriate government intervention may well be to promote more competition rather than enter the market and compete with the competitor. In Canada in the '70s, we have seen the government enter the retail gasoline market as well as upstream exploration and development through a state owned enterprise in order to have a "window on the non-competitive market" (Fossum, 1997).. This just added one additional, inefficient player to a highly concentrated, uncompetitive industry. The company PetroCanada was ultimately sold to the private sector and market power has been reduced by promoting entry and competition. Often the best policy for promoting competition is to reduce barriers to entry such as tariffs and non-tariff barriers and open the market to foreign competition.

➤ Natural Monopoly

Where a market is dominated by downward sloping marginal costs that are a clear natural monopoly, there is a temptation for the state to own and operate the monopolist (Baumol 1982). Many postal, telecommunications and telephone companies have started this way. As noted above, at the outset of the industry and product, with the original technology a natural monopoly may well be justified and state ownership and operation may be optimal. However, with the advent of technology and industry efficiencies, the natural monopoly may well become a relic and inefficient. Once run as a monopoly it is very difficult to privatize. Royal Mail is a successful example, but even then, while it competes on parcels, it still has effectively a letter mail monopoly. And its privatization was very contentious and politically difficult.

➤ Transactions Costs

▪ Reducing Transactions Costs

Companies exist to internalize and reduce transactions costs (Coase 1937). Sometimes, governments can reduce the transactions costs of market transactions. For instance, where there are informational asymmetries and informational costs, governments can collect or produce the information and disseminate it at close to zero costs (Williamson 1981).

There are often times that governments can reduce transactions costs by centralizing some processes. Thus where the costs can be borne by government and centralized distribution lowers aggregate costs, then society is better off.

- **Bearing Transactions Costs**

However, where the costs are absolutely present, cannot be reduced and government bears the costs without reducing them, then the solution is clearly sub-optimal. Government can bear the costs and improve everyone's well being where the transactions costs must be present, can be reduced and the only way to reduce them is to have government bear the costs.

The great danger is that when governments bear the costs then the incentive to reduce costs gets dissipated.

- **Risk Management**

Risk management is another classic justification for government intervention. Sometimes, it indeed is justified. However, often it is merely an excuse for some bearers of risk to have the objective and ever present risk shifted from them to the collectivity.

There are several often unarticulated rationales for government bearing the risk. It is valuable to unpack these and examine the extent to which they are justified (Sunstein 2011).

- **Risk Reduction**

The most easily justified of government interventions is where the intervention objectively reduces the risks (Posner 2004). Building of a dam that reduces the risk of flooding (not all such dams do) would be an example. However, if there is proper property rights allocated, it may be sufficient to allow the individuals living downriver to finance and build the dam or bridge. On the other hand, where all will benefit by the actual reduction of costs, then the intervention of the state may be justified. In all circumstances where the government intervention actually reduces risk, there is likely to be a Pareto improving solution.

- **Risk Pooling**

This is one of those areas most easily justified for government intervention (Sunstein 2004). Where all risks are pooled across all citizens on the basis of truly stochastic events then the government may well be justified in intervening. If risks can be discerned and segregated then it is not necessarily justifiable for government to intervene. If risks can be pooled across subgroups of the population having specific characteristics then it is not clear why private insurance cannot provide optimal allocations. Government intervention where

the *ex ante* risks are severable and identifiable will lead to suboptimal risk taking and extensive cross subsidization. If all risks are truly stochastic and equally applicable to all, then government provision of the insurance or government mandate of private insurance may well be justified. Once again, *ex ante* information asymmetries may guide whether government intervention is justified

- **Risk Sharing**

Where the risks are clearly differentiated across identifiable groups then the risks can be shared, but it is not clear why government would have to be the instrument of cross subsidization. Rather, risky actors could use other institutions to share the risks like forming families and clubs and other vehicles for risk sharing.

- **Risk shifting**

Where the government intervenes to shift the risk without either pooling or reducing it, but shifts from individuals to the collectivity, then there is likely to be perverse incentives that would lead to behavioural adjustments that actually make the collectivity worse off.

In the case of risk management, it is very important to unpack the nature of the government intervention, look at its actual effect and decide if it is reducing objective risk, pooling unreducible risks, or just shifting them or sharing them.

- **Instrument Choice**

Governments should always assess the efficacy of their interventions and avoid those instruments that are inefficient. When you say it fast, it sounds easy. However, this again, is often honoured in the breach. Instrument choice and the efficacy of possible instruments are crucial in the assessment of whether government should intervene or not (Hood 1976).

Indeed, direct delivery is usually the first choice of governments in applying their program and policy choices. However, it is never clear that this is optimal. While government perhaps should be engaged in the policy area, there are almost always variations in the delivery mechanisms that should be used (Hood 1983).

Governments must assess whether legislation, regulation, direct service provision, public private partnerships, financing arrangements, third party delivery, self regulation and a whole host of other options is desired for the efficient and effective accomplishment of the policy objectives. In many cases, it will be a non-intuitive, creative alternative to the program delivery that is optimal.

❖ WHAT GOVERNMENTS SHOULD NEVER DO

If the theme of this paper is that there are no absolutes, then there should be no activities that governments should never do. However, as noted above, there are many interventions of government which can be justified in some circumstances and not so in others. Nevertheless, what follows are a few interventions or classes of actions that government can almost never be justified in doing. And while there may be some remote circumstances where it could be rationally justified, the overwhelming difficulty of adapting to changing circumstances and withdrawing the intervention once the technology or market has changed, means that governments should basically never undertake them.

The following are merely examples of initiatives that governments often undertake and yet even though circumstances change, they almost never get out of.

➤ Regional Development

In Europe and Canada, we have extensive policies that are intended to promote regional development. However, regional development implies a creation of winners at the expense of some losers (OECD 2013). Moreover, once begun, there develops a constituency dependent on the largesse that does not allow governments to easily adapt to changing circumstances, or even to claim success.

Moreover, most often regional development policies are used to thwart the natural functioning of markets. Where a region becomes inefficient or loses its comparative advantage, it should go through adjustment and government may try to promote positive adjustment policy. But often such interventions are intended to retain the inefficient industry, inhibit adaptation or reduce the costs of adjustments by creating barriers to adjustment or disincentives to adjustment.

In Canada, regional development has been used to promote economic advancement in the Atlantic provinces notwithstanding the low levels of human capital and decline of resource industries. This has thwarted adaptation and adjustment and resource reallocation across the Canadian economy (Savoie 1992).

➤ Income Maintenance

Like Regional Development, attempts to maintain incomes through seasonal benefits for Employment Insurance, while relative prices and wages are adjusting has led to perverse incentives that have thwarted adjustment, maintained inefficient production and ultimately disadvantaged the beneficiaries by slowing the necessary adaptation (Betson 1985).

Moreover, when transfer programs have been used to top up market incomes by redistributing income they often have led to disincentives to work. This area has become subject to extensive analysis and policy development and programs like the Earned Income Tax Credit in the US and the Working Income Tax Benefit in Canada have attempted to compensate for the disincentive effects of 100% or almost complete marginal effective tax rates on benefits for the working poor.

So long as managing transitions between categories of beneficiaries is difficult, then efficiency will be reduced and disincentives will be created.

➤ **Market Delivery**

Where government intervention is justified, it is not usually justified to have government delivery of a market product. So, it may be lower cost with risk pooling for the state to pick up garbage. But it does not mean that the workers of garbage pickup must be state employees. So, the contracting of the private sector for delivery of public services may be more efficient. The contracting of the private sector to build public buildings is not in dispute. Other innovative variations like Public Private Partnerships may also be desirable where the ultimate product is the public good, but the actual delivery can be more efficiently provided by the private sector.

➤ **Attempt to bear or naively reduce risk**

Where governments provide emergency services and reduce costs, but then inadvertently shift the risk to the state and induce people facing the lower cost to increase their risk taking behaviour without facing the real cost of their actions, then society is worse off.

The preceding are some examples of what government should never do. Even in these it is clear that it is circumstantial where government should or should not engage in the provision of the services.

❖ **THE CANADIAN CONUNDRUM.**

➤ **The impending crisis, the response, and the payoff**

Through the decade of the '80s and early '90s of the last century the Canadian government attempted over and over again to unsuccessfully reduce its spending. Its deficit was growing rapidly and thus its debt. By the mid '90s the debt to GDP ratio had exceeded seventy per cent and the deficit was running over forty percent of revenues. That means that while taxpayers were paying a dollar in taxes, they were receiving only 60 cents of services. If it felt like government was not a good buy, it was because it was not.

By the mid '90s the international markets were already starting to get jittery about the Canadian dollar. The Wall Street Journal called Canada a Northern Banana Republic. The run on the Mexican peso sent a chill through markets in Canada (Martin 1996).

The Progressive Conservative (centre right) government of Brian Mulroney had attempted to restrain spending but through marginal reductions in operating costs without fundamentally addressing the rationale for the existence of programs.

However, as the then Deputy Minister of Finance, David Dodge (who went on to become the Governor of the Bank of Canada) noted, "When the pattern of the brick work on the wall you are about to hit becomes evident, you have to take evasive action."

The Liberal government of Prime Minister Jean Chrétien did what was most unlikely for a centre left government. It actually dramatically cut government spending. It did not raise taxes. It cut spending. The Minister of Finance, Paul Martin (who went on to succeed Chrétien as Prime Minister) and the Prime Minister did so in a dramatic, unlikely and disciplined fashion.

It cut government spending by 20% in one year where all programs were "on the table" as the then Prime Minister said. Transfers to business were cut sixty five per cent. Transfers to provinces were cut fifteen percent. And transfers to individuals were frozen. So-called economic departments like Environment, Natural Resources and Agriculture were cut 30-35%. Over 40,000 public servants were let go (Bourgon 2009).

At the time the Department of the Environment (where the author was Deputy Minister) had a 33% budget reduction, and fired 35% of staff over three years. We closed offices across the country and went from 72 offices to 19. Some departments went through deeper cuts.

The cuts were determined by principles that were fundamentally calling into question the role of government. After years of expanding government programming and spending, many programs had constituencies that were dependent on them but which were otherwise no longer justified.

While the programs originally might have been justified as externalities or market failures, after the passage of time, they were much less justified. The review process was done by Ministers. Ministers were given discretion, up to a point to decide where to take the cuts within their department.

The fiscal crisis presented the government with an opportunity to fundamentally review all spending and to ask tough questions.

They applied the following guiding principles:

Primo: Government should only do those things that only government can do.

Then the following criteria were applied:

1. Does the program continue to serve a public purpose?
2. Is there a legitimate and necessary role for government in this program area ?
3. Should this program be delivered by another level of government?
4. Could this activity better be done by the private sector or perhaps the voluntary sector?
5. Is the program being delivered in the most efficient fashion?
6. Is the package of programs affordable in the context of fiscal constraint and if not, which are the marginal programs to be cut?

Applying these criteria, and imposing dramatic fiscal restraint, the government was able to get out of many lines of business that were no longer justified. That they had been created as programs may show they were justified at some point, certainly in the mind of the government of the day. However, by 1995 many of these programs had become unjustified and should have been cut. But politically it required a crisis to force tough decisions.

➤ The Payoff

By government not doing those things that are unjustified or unnecessary, there are several benefits that accrue. The following is a list of just a few such benefits that obtain when a country regains its fiscal sovereignty. Fundamentally, governments are faced with choices when they no longer engage in unnecessary or unjustified activities (OECD 2012).

Continuing surpluses: After cleaning up the spending on programs unnecessary or surplus to requirements, the government went into fiscal surplus after three years. And it sustained continuing surpluses for twelve years until the global financial crisis of 2008. By that time the debt to GDP ratio was down to virtually thirty per cent from over seventy per cent. After running an expansionary fiscal policy with significant deficits in response to the global financial crisis, the government will return to surplus this year.

Paying down the debt: With the choices to be made in the use of the surplus, the government chose to spend part of the surplus each year in paying down the debt. While growth in GDP helped bring the debt to GDP ratio down, absolute reduction in the debt (from 765 billion to under 500 billion) brought it down that much more rapidly.

Reducing taxes: With fiscal sovereignty and choices possible, government could actually return some of the overtaxation to taxpayers through tax

reductions. The current government reduced the VAT by two percentage points, a reduction of a quarter of the federal Goods and Services Tax.

Weathering shocks: With a cleaned up fiscal position, and robust economic growth pushed by reduced fiscal drag the economy was in a much stronger position to deal with the global financial crisis of 2008. Thus, Canada had the least reduction in employment, the most growth in GDP and the least reduction in tax revenue of any G7/G8 country. While the adept fiscal, monetary and economic management of the Prime Minister, the then Minister of Finance, and the then Governor of the Bank of Canada were instrumental in positioning Canada ahead of all G8 countries in economic performance, they acknowledged that the fiscal, programmatic and economic clean up of the '90s allowed Canada to so perform.

Fiscal and Monetary Policy alignment: With an independent central bank and a growing demand among the public for fiscal responsibility, it becomes very difficult for governments to behave profligately. Moreover, the alignment of fiscal and monetary policy positioning becomes that much easier.

➤ **Lessons from Canada**

What can we take away as lessons from the Canadian experience?

First, there was no light between the Minister of Finance and the Prime Minister.

Second, there were no exceptions to the rule of dramatic cuts. All Ministers were in.

Third, the principles applied went fundamentally to the role of government.

Fourth, counter-intuitively, it was easier for a centre-left government to dramatically cut government spending than for a centre-right government to do so. The Progressive Conservatives with their modest cuts had been accused of being black hearted accountants. But, no one doubted the Chrétien government's instinct to spend. When they explained the need to cut, it was far more easily justified.

Fifth, it was worth going deep. The cuts of three and five percent of operating budgets had been attempted. It was necessary to make this non-marginal in order to force the choice of programs and to actually get out of lines of business.

Sixth, it was worth going quickly. Had the government given itself more time, as officials all wanted, it would not have been accomplished. Rather, getting over the trauma of the cuts quickly was necessary to maintain quality of service.

Seventh, it was advantageous to undertake this cut process at a time when the economy was growing robustly.

Eighth, it was necessary to face a crisis to force the necessary return to responsible program design.

❖ **Conclusions:**

There are very few functions that governments should never do. But, equally, there are few functions that governments should do. Mostly, there are many functions that governments might do, in some circumstances, if they can be justified. And if they can ensure that they will be reviewed periodically for continuing rationales. Canada has several lessons worth considering in the review of what governments should never do.

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