Chapter 2

Government Functions and Policies

2.1 Introduction

Interventionism as a fact of everyday life was solidified by mercantilist principles during the period when the British empire was spreading its wings around the globe. Debunking of mercantilism, although masterfully done by Adam Smith, could not be immediately implemented as by that time it became an accepted way of British policy and life. Until the classical economists, exclusively motivated by British interests, finalized their system, the spread of industrial revolution and the concomitant expansion of international trade laid firmly the foundations of the golden era of political economy. As years passed and laissez-faire with its various faces was practiced in industrializing countries, interventionism was losing its steam and public finance was moving away from the centre to the periphery of economic thought. The catastrophic consequences of the Great Depression were the motivating forces behind the development of the Keynesian system, which legitimized government interference and hurled fiscal policy back again into the mainstream of economic theory and policy.

Attacked by monetarism, Keynesianism was retreating and, along with the loss of some conviction in its premises, the advent of rational expectations with its absolute faith in instantaneous, if not perfect adjustments of the private sector, in an information-filled world, to emerging conditions, undermined the importance of government economic activities. However, government having assumed over time a multitude of responsibilities could not discard them momentarily and most definitely not its economic growth responsibilities on the success of which re-elections depend. These responsibilities are in their own right macroeconomic in nature. In essence government is nowadays inextricably bound to the overall performance of the economy. Macroeconomic
policy is the subject of this book. The second section of this chapter gives the theoretical rationale of government activities. It is followed by a section devoted to an evaluation of the main theories of government growth, as a prelude to the presentation of the empirical results of public expenditure investigation in Canada in the next chapter. The conclusions of this chapter are summarized in the fourth section.

2.2 Justification of Government Spending

Excepting anarchists, no thoughtful person questions the raison d'etre of government. Yet, among thoughtful individuals, there are disagreements as to the range of government activities which ultimately determine the relative size of the public sector. Extreme arguments that governments do not create a single job offset equally extreme positions arguing for a complete socialization of the means of production that are seen to be inefficiently utilized in private markets, leaving in the process a large space within which the legitimate functions of government are decided in democracies. No inviolable criteria exist to determine for all times these functions, which vary in response to different influences that mould the preferences of a country as a result of continuous interactions between electorate and political parties. Ideologies aside, whose shifts shaped by domestic and foreign developments may historically cause significant fluctuations in government size, a basic core of government services exists, which must be provided, even though the extent of provision varies from time to time and from country to country. This core is known in public finance as social wants, and they are characterized by the attributes of indivisibility, nonexcludability and by implication nontransferability, and joint consumability. These attributes confer an inordinate degree of externalities to the social wants satisfying commodities to the extent that, once provided, they indiscriminately benefit all citizens, so that firms unable to capture for themselves the conferred externalities have no incentive to engage in their production. Consumers, as self-interested "free riders" even though valuing the goods or services provided, are unwilling to reveal their true valuations or preferences, and must therefore be coerced by government to pay for the provision of these commodities.

The other class of public goods supplements private production which government considers as falling short in quantity or quality of the requirements of society as a whole or of sections of it. The wants satisfied by these collective goods are referred to by Musgrave (1959) as merit wants. Compared to social wants, which in the system of Adam Smith mainly comprised defense, the administration of justice, and the main-