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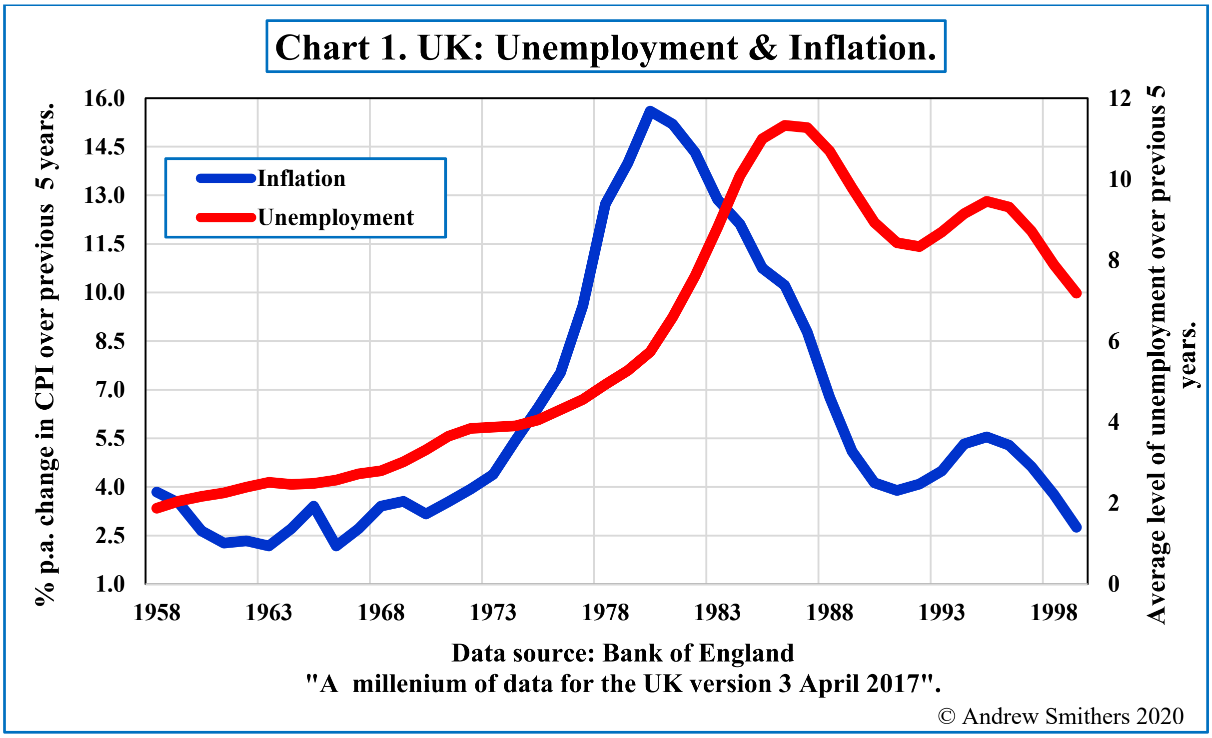
The Economics of Covid-19.

Economics is not good at forecasting but better at cures. We need to switch from the former, which dominates the news, and concentrate on solving our major problem. Before the pandemic this was stagnation, we now face the prospect of a long-term decline in our standard of living. Since the end of the World War II financial journalists have concentrated on how demand should be balanced to avoid either unnecessary unemployment or rising inflation. The apparently unthought justification for this myopia, was the assumption that the economy's ability to produce and supply goods and services rose year by year by a process which was automatic or too boring to justify serious attention. As well as demand, we need to worry about supply, our ability to produce, and this was urgent even before the pandemic. Since the recession GDP per head has only grown at just over 1% p.a. The pandemic will slow growth not just this year but on a continuing basis. Unless we make a major change in the way we manage the economy, we risk a sustained fall in living standards. As well as making us miserable this threatens to destroy voters' trust in liberal democracy.

Damage limitation is the short-term goal, which means limiting bankruptcies and managing demand so that we avoid inflation and needlessly high unemployment. If a short-term collapse in profits causes viable businesses to go bust our capacity for recovery will be damaged. This is a solvency not a liquidity problem. When companies become illiquid, the underlying business can usually be saved after refinancing, but if many suffer at once the supply of skilled bankers and accountants will be insufficient to prevent their businesses from going under. The difference between insolvency and illiquidity and between companies and their business needs to be understood. There will probably be mistakes made in the implementation of policy, but we seem to have started sensibly with the provision of grants, including wage subsidies, which address the problem of insolvency and guarantees for loans, which address the issue of liquidity.

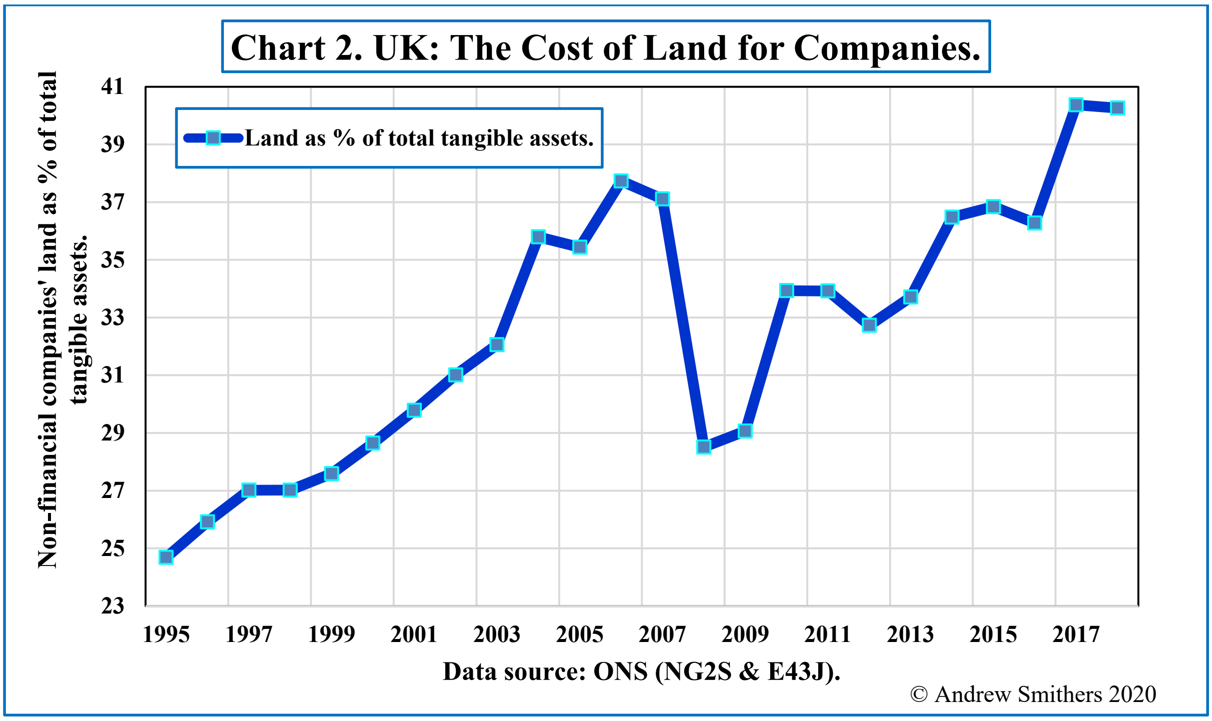
Unemployment is often and reasonably seen as a worse evil than inflation. If inflation did not cause high and sustained unemployment it would be sensible to favour the risks of inflation over those of unemployment. The lesson of the oil crisis, which was the major supply shock before Covid-19, is that inflation causes unemployment, which is both high and sustained, while the unemployment that comes when inflation is low, can readily be cured by boosting demand. Rising inflation is therefore the mistake we must avoid. When it does it will, if not immediately halted, cause expectations of future inflation to pick up and we then enter a vicious circle in which these lead to inflation accelerating. We then have stagflation in which both inflation and unemployment rise. To bring this under control there has to be a shock rise in interest rates, which hit 16% in 1980. Unemployment then goes up even further and takes years to fall back to its previous level (as Chart 1 shows).



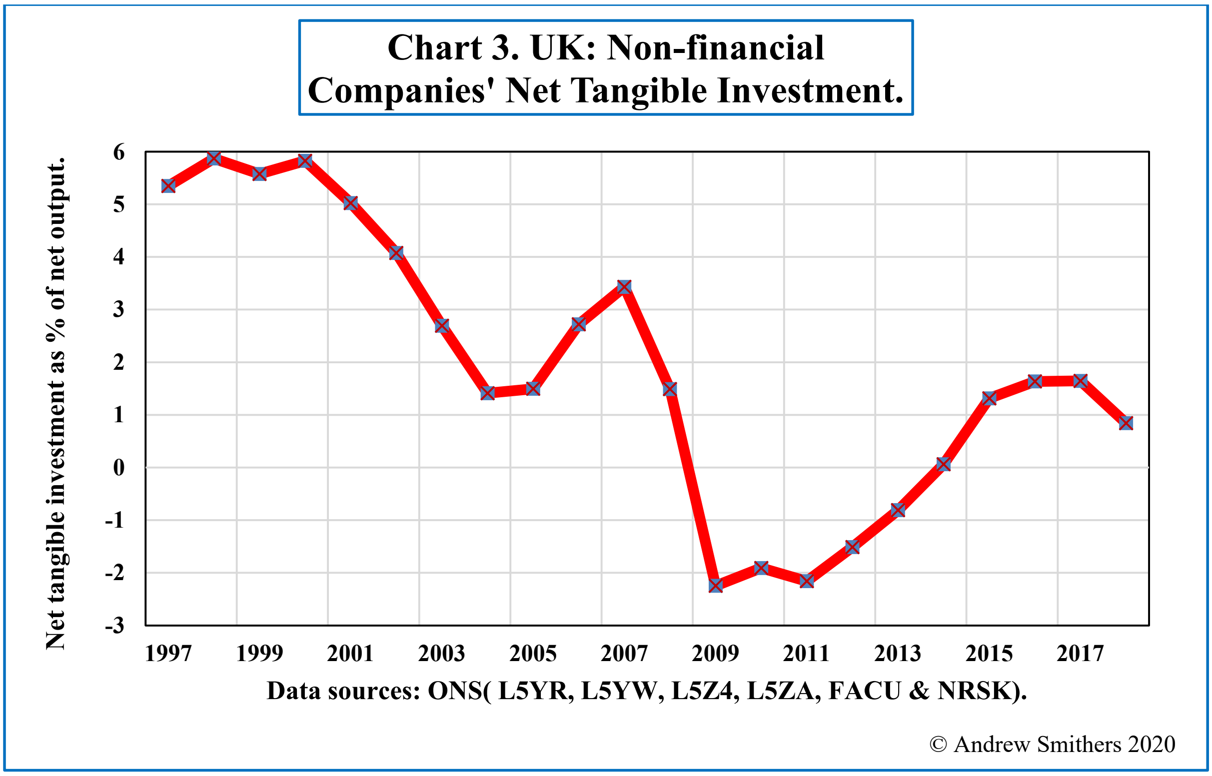
Claims that deflation is a greater danger than inflation, which have been common, (including the Financial Times leader of 28th April) are therefore wrongheaded. They are also nonsense as forecasts. Inflation is measured by the prices of goods weighted by the amount spent on them. These weightings have in the past changed slowly but will now alter sharply. If, as has been past practice, 2019 weightings are used to measure 2020 inflation it will be dramatically understated. To illustrate this I divide the economy's output in two. Half for which demand rises, while for the rest it disappears. If output is at full capacity for the part where demand rises, the economy's ability to supply goods and services halves. There is no demand for the other half so its prices will fall to near zero. If prices rise by 10% for the items in demand, inflation will be 10% on the 2020 expenditure pattern, while prices will halve on the 2019 pattern. Prices are observable and changes in weightings are not; to the unreflective therefore it will seem obvious that the pandemic is deflationary.

Our habits inhibit change; when we are forced to alter them, their power to delay weakens. Our physical presence at the office and at conferences is seldom needed but habit, sociability and the fear that in office politics the absent are blamed, has slowed the growth of video discussion and working from home. Travel, both for commuting and international business and the use of office space have been boosted at severe economic cost. Studies have long shown that long working hours reduce efficiency and even output if they are regularly over 10 hours a day. Commuting is not the same, but it is tiring. Anecdotal evidence already indicates that efficiency has risen with more working from home.

The more land costs, the less can companies invest to get the same return, so countries with low land prices have an advantage. The old joke that land is expensive because god has stopped making it, misses the point that business needs land to build floor space in the right location and the price of land therefore depends on the marginal cost of creating floor space, which includes getting planning permission. For UK companies, the cost of land has shot up and now amounts to 40% of the tangible assets compared with 24% in 1995 (as Chart 2 shows) when the data start, and is now about three times as expensive as it is in the US.



A large fall in land prices should help encourage companies to invest more, but the main reason they haven't is the bonus culture. If we are to get growth back to a rate which will satisfy the reasonable expectations of voters, we must reverse the damage that this has done to the economy and the pandemic provides the opportunity as well as increasing the need to do so.



Growth varies over the short-term around a longer term trend which depends on the growth of the capital stock, excluding land. To get this to grow more rapidly we must invest more. A dramatic change in the way company managements are paid took place in the 1990s with the bonus supplements to basic salaries rising 2.7 times between 1997 and 2000 for the bosses of FTSE 100 companies. This caused a sharp drop in business investment after 2000 (Chart 3). Investment is essential for companies' survival. If competitors invest more, their costs will fall and they will gain market share through lower prices or spending more on marketing. But investment halts profit rises in the short-term, as the additional capacity comes in lumps and it takes time for sales to catch up. Managements are therefore often faced with a choice between short-term profits, on which their bonuses depend, and longer term job survival. The bonus culture shifted the balance against investment by increasing the short-term rewards for managements when profits rise.

The pandemic, which will slow growth, will increase the need for it to finance the national debt. It is currently 80% of GDP and Covid-19 will increase it sharply. (For the debt ratio to fall government spending, excluding interest payments on the debt (the basic balance), can exceed tax revenue by the difference between growth and the real rate of interest multiplied by the ratio of national debt to GDP.) At our post-pandemic debt level, a rise in growth of 1% p.a. would reduce the need for tax increases by 1% of GDP.

Wellbeing rather than output is the source of happiness, so some argue that we should not worry if the growth in output slows. But the growth of output makes an essential contribution to our happiness in two ways. The increase in our welfare that comes from higher incomes is less than the equivalent pain that comes when they fall. In a stagnant economy, those whose incomes rise are matched by those that fall. The pain thus outweighs the joy and people will be more miserable than if the economy grew and the faster it grows the less misery there will be. Our current sense of wellbeing also depends on the expectation that growth will improve the opportunity for our children and grandchildren to have interesting and fulfilling lives.

We must therefore boost growth.

(i) Because the current rate is already too slow to meet voters' reasonable expectations and maintain their confidence in liberal democracy.

(ii) The Covid-19 will slow this further: without change we risk a long-term fall in our standard of living.

(iii) Faster growth will reduce the need for future increases in tax, which might otherwise be too unpopular to be politically feasible.

(iv) Weak investment has caused weak demand. The fiscal and monetary boost to offset this causes ever increasing debt; stronger investment would halt this unsustainable process.

Boosting Growth.

Business investment has fallen because of the dramatic change in the way companies' managements are paid (the bonus culture) ([1]). Changed incentives have altered behaviour perversely for the economy as it has caused investment to fall. To have a satisfactory growth rate we must generate more confidence or reverse this damage. Rising investment should boost confidence so success in reversing the negative impact of the bonus culture should receive an added boost by engendering a rise in the what Keynes called the animal spirits of entrepreneurs.

There are three ways in which the damaging impact of modern management remuneration might be ended or even reversed. The most modest is to improve our knowledge about the productivity performance of individual companies, the most radical is to regulate the terms under which bonus type payments are made, and the most likely to succeed is to reform corporation tax by introducing tax credits for tangible investment so that the incentive for managements is to boost rather than depress investment. The level of corporation tax could be adjusted so that its revenue would not alter, high investors would pay less and low investors more.
(Under the current system companies tend to have lower profits or at least smaller increases in the short-term if they invest. If tax credits were given for tangible investment, this would reverse so that profits after tax would rise with investment in the short-term. The change would therefore not just remove the current disincentive to invest, it would reverse it and change the economic impact of the bonus culture from

[1] For a full explanation see *Productivity and the Bonus Culture* by Andrew Smithers Oxford University Press (2019)

perverse to beneficial. This reform of corporation tax is thus likely to be the most effective way to stimulate investment and boost growth by improving labour productivity.)

The essential condition for any effective change is public understanding and debate. I have referred to the apparently unthought justification of the myopic view that has caused public debate to be almost entirely restricted to demand management. I am therefore hopeful that the pain and distress that the pandemic will cause will be accompanied by a determination to manage the economy better than before by discarding the blinkered myopia which has held us back from doing so earlier.

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