The COVID-19 business policy response – what now?

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When the economy was wound down in late March by the government's response to the COVID-19 pandemic, policy was rapidly made to protect businesses and jobs. The policy settings were relatively permissive: there were limited restrictions on eligibility for subsidies and benefits seemed intentionally fairly generous.

During Alert Level 4, the government's objective was to curb COVID-19 by severely limiting (economic) activity. If assistance had not been provided, then there was a risk that people would attempt to reduce the impact of the restrictions on their income and go about their normal business. This would have been counterproductive to the goal of eliminating COVID-19.

We are moving into a new phase of the pandemic response, in terms of what business can operate and what civil interaction is permitted. We are also braced for a significant economic contraction: the Treasury released a set of scenarios in April that showed a best case outcome of a decline in annual GDP of 13%. So, what should the government's policy toward helping businesses be now?

It is a critical question: policy during a crisis should not be allowed to morph into long-term policy; at some point businesses must be able to operate on their own merits. A backstop, in the form of government-funded protection, encourages risky behaviour and protects businesses that would have failed anyway (without the pandemic). Ultimately, this gives an unfair advantage to these businesses compared to those that do not have access to the subsidies.

These are not new problems of course. Nobel prize-winning economist Kenneth Arrow coined the term "moral hazard" in the 1960s. Moral hazard describes the "hidden actions" of an insured person who takes less care because they are protected from the full cost of their actions. Long before that though, in the 1870s, Walter Bagehot articulated a rule for central bank lending during a liquidity crisis. He said that lending should be freely available to those with good collateral but at penalty rates. His argument was that making lending available as largely as was asked for, provided good collateral was available, would "stay the panic" because in normal circumstances these businesses would have access to capital. The high interest rate would ensure that only those who required it (and by implication could pay for it) would apply for a loan.

Bagehot's rule was written for a different situation, and I am not suggesting his policy solution be adopted now. Nonetheless I think Bagehot's rule provides sound guidance for mitigating moral hazard when crafting a government policy package to support businesses:

- Focus on resolving the policy problem (I would add: ask the right question)
- Consider what businesses would be able to expect or access in 'normal' conditions
- Use the tools at your disposal, including prices, so businesses self-select, if possible

Getting it right will require complex thinking: consumption patterns are likely to be altered for a significant period of time, if not permanently, as our ability to buy particular goods and services is restricted. Workers and capital should be allowed to move into production of things that people want and are able to buy. Policy should not inhibit this transition. At the same time, government is no doubt aware that such transitions are inevitably costly to those whose products and services are no longer in demand and individuals may require assistance.

Mistakes are inevitable as the fear of letting businesses fail competes with the worry that viable businesses are simply struggling to access capital. It's something that will no doubt be much debated. In the meantime, I give the final word to Bagehot: "The amount of bad business in commercial countries is an infinitesimally small fraction of the whole business. ... The great majority, the majority to be protected, are the 'sound' people, the people who have good security to offer." (Just remember to check.)

About the author

Vhari McWha is an experienced economist and advises on public policy and regulation, including developing pricing methodologies for natural monopolies. She has extensive skills in quantitative analysis, including cost benefit, modelling and forecasting work. She has advised on a wide range of complex issues across the New Zealand economy and has particular experience in the energy sector. Read more about Vhari and her expertise here: https://www.srgexpert.com/our-people/vhari-mcwha/

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