

The “cost” of Covid (redux)

By David Hearne, Researcher, Centre for Brexit Studies

Wednesday’s Spending Review means that a great deal of ink has already been spilled on how to “pay” for the costs (including, notably, business support) of the Covid pandemic. The headline figures are, of course, eye watering.

Vast sums of money are – rightly – being spent on supporting businesses and employees at present, although many will feel that even this isn’t enough in some sectors. Billions more are being spent on Test & Trace, PPE and providing funds for councils to undertake local public health work.

However, whilst it’s right that such support is pared back as the crisis (hopefully) eases next year, it’s also clear that there will be ongoing damage to the economy that will take years to recover from. This is in addition to the longer term deleterious impact on economic growth that the Office for Budget Responsibility estimates will come as a result of Brexit.

As a result, the government is planning measures to reduce state spending – most notably by freezing a substantial proportion of public sector wages. Now is not the right time for spending reductions. There is a clear reason for this. Firstly, interest rates are at their lower bound and the Bank of England has already undertaken a large volume of Quantitative Easing (QE). Inflation is below target.

As a result, the burden of macroeconomic stabilisation rests heavily on fiscal policy. Fiscal retrenchment – even the extremely modest measures outlined so far – risks doing more harm to the economy.

A common public misconception is to treat the government like a household. If I spend more than I earn, then as Micawber says, “result misery”. The government is not like me.

The government lives forever. In contrast, most of us have a working life of under 50 years. Similarly, my spending represents an

infinitesimally small part of the overall economy – the aggregate impact of me borrowing money and spending it all is essentially zero.

That is not true for the state, whose total overall expenditures are substantial relative to GDP (around 41% in the case of the UK). As a result, the state can have a substantial impact on the overall economy in a way that I cannot.

Finally, the state has a central bank. As a result, it cannot go (involuntarily) bankrupt in a conventional sense. Instead, the concern is over runaway inflation.

Yet we are a long way from this. Inflation was 0.9% in October^[1] and the cost to government of servicing its debt is actually falling^[2]. Indeed, at the time of writing, the yield on 5-year gilts (UK government bonds) is actually negative. Investors are – quite literally – paying the UK government to borrow money.

Yet amongst commentators on the left and right of the political spectrum, concern abounds. Why might this be?

I suggest that the answers are – at least to a significant extent – to be found in a recent survey undertaken by the Economic Statistics Centre of Excellence run by the National Institute of Economic and Social Research. They found that the level of understanding of certain key concepts (such as GDP) was weak^[3].

However, it's also the case that even amongst those whose understanding is excellent, knowledge is extremely domain-specific. Comparing GDP and productivity in different countries is a case in point.

This depends crucially on several different factors. Firstly, there are multiple measures of productivity – labour productivity, total factor productivity etc. In the case of the latter, should one make an adjustment for levels of education?

If so, how do you compare vastly different education systems? The measurement of capital can present a fiendish challenge.

Similarly, even in the simplest case, equivalent (and accurate) measures of hours worked need to be calculated. For those paid hourly this is straightforward. For others, however, who might put in time outside of normal working hours it can be complex.

Then we need to accurately measure relative prices. This is a complex field that has stimulated an enormous wealth of research in its own right, made more difficult by the fact that many poorer countries struggle to source accurate measures of prices.

Even nominal GDP can be difficult to measure and define. Should activities that are illegal (narcotics and prostitution, for example) be included? If so, how do we measure and price them – they're hardly amenable to normal business surveys!

Perhaps, then, some of peoples' scepticism over data and its use is warranted (at least in part). The unwanted side effect of this, of course, is that we are vulnerable to misinformation or simple misunderstanding.

Often, "common sense" and the received wisdom come to our rescue. Sometimes, however, they lead us seriously astray. Discussion of the government deficit and optimal policy is a case in point. What's worse is that this is inevitably politicised. What should be academic is reduced to ideology.

We see exactly the same issues in relation to vaccines and global warming. Misinformation and conspiracy theories are rife. Most of us are instinctively hesitant to trust something we don't fully understand.

Worse, we know that humanity's understanding of all of these things is partial. As in all fields, there are things we are very confident of and things we are less confident of. In the case of Brexit and trade, we can be very confident that any increase in trade barriers (tariff or non-tariff barriers) will lead to less trade.

The finding that countries trade more intensively with partners that are larger and (physically) closer is extremely robust. It follows that we can be confident that Brexit will reduce trade between the UK and EU (and some evidence suggests that it already has). However, there is much greater uncertainty over the magnitude of such changes.

The upshot of all of this is that it is too easy to simply declare “government deficit bad”, and accept actions to reduce it as being therefore axiomatically “good”. However, what is good in one circumstance can be very bad indeed in another. In this particular instance, we should follow St. Augustine: “Lord make me chaste [...], but not yet”!

[1] <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/october2020>

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938052/SR20_Web_Accessible.pdf

[3] <https://escoe-website.s3.amazonaws.com/wp-content/uploads/2020/11/24191147/ESCoE-OP03-Public-Understanding-of-Economics-and-Economic-Statistics.pdf>