POLICY POINT

For better or for worse: How governments respond to crises

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Introduction

As New Zealand nears the end of the Covid-19 public health emergency, all eyes are on the economic recovery. The New Zealand Government has already indicated the post-recovery world will look quite different. It has also given itself great flexibility in designing policies for this crisis. For example, it has temporarily suspended the financial scrutiny forms called Regulatory Impact Statements, relaxed visa rules and is about to relax planning procedures.

Though understandably, the Government wants to move quickly, it is important not to rush policies. If the experience of past crises is anything to go by, there is a danger that well-intentioned crisis measures can become wasteful exercises and provide a quick employment hit at the expense of long-term fiscal liabilities. New Zealand must avoid such flash-in-the-pan experiences. Instead, it needs a sustainable, long-term strategy for a lasting recovery.

This paper looks at the structural conditions that make for such good recovery policies. It also offers examples of international recovery policies that went wrong and serves as a warning not to choose a quick economic sugar hit over a more wholesome economic diet.

The importance of fiscal headroom

In a 2019 paper by US-based macroeconomists David and Christina Romer, data for 30 OECD countries between 1980–2017 was used to examine the relationship between fiscal headroom before the onset of crises, the fiscal policy responses and the aftermath of those crises. The husband and wife duo found countries with lower debt-to-GDP ratios responded with more expansionary fiscal policy and were better off.

They showed how facing a crisis with a debt ratio one standard deviation below the average was associated with a fiscal surplus after a crisis roughly four percentage points smaller (that is, more expansionary) than entering a crisis with a debt ratio one standard deviation above the average. Low-debt countries experienced much milder downturns after a crisis than high-debt countries.

New Zealand was fortunate to have relatively low levels of public debt before the Covid-19 crisis began. This means the country can reasonably expect a less severe downturn over the near future than if its debt levels had been higher. The Romer's results also show the importance of keeping debt levels in check with an eye to the next crisis. While New Zealand has the fiscal headroom now to stimulate the economy, that does not mean the Government should hastily implement expensive policy initiatives and risk policy failure and unintended consequences or undertake investment projects for which the benefits do not outweigh the costs. History provides plenty of examples encouraging caution here.

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For instance, to help stimulate demand, support flailing automakers and fix some environmental concerns the US introduced the 'Cash for Clunkers' scheme in 2009. The Federal Government offered incentives of between $US2500 and $US4500 to US residents when they traded in a gas-guzzling, older vehicle for a newer, more fuel-efficient car.

The programme cost the American taxpayer billions. However, estimates suggest about 60% of the subsidies were claimed by consumers who would have bought a new car anyway which meant there was no real difference in new car ownership between those eligible for Cash for Clunkers and those who were not. On top of that, since most fuel-efficient vehicles tend to be cheaper (and often are imported), consumer spending declined.

In Australia, the Home Insulation Programme (HIP) was introduced with similar goals of stimulating demand and jobs. The programme created a $A2.8 billion frenzy of activity. Prior to the scheme, roughly 70,000 houses were retrofitted with insulation every year, but at the height of the HIP, about 180,000 were completed in a single month. Yet because regulation and training had not caught up with the scheme, much of the finished work was unsafe, unsupervised and even lead to several deaths.

Another example of a quick-fix government scheme from Australia was its 2010 Nation Building Economic Stimulus Plan, a two-stage group of 28,000 local government projects at a total cost of about $A52 billion. Then-prime minister Kevin Rudd said the plan would protect against a nationwide recession after the global financial crisis (GFC) by building strong future infrastructure.

While many projects were no doubt chosen using sound economic reasoning, it also led to some bizarre choices. For instance, the New South Wales town of Carcoar – a sleepy village of 218 residents with an average age of about 50 in 2006 – suddenly found council workers building a very expensive new playground for only 34 children.

A related programme in Australia, Building the Education Revolution, was a $A16.2 billion plan. A report written in 2013 by an oversight taskforce found about $A1.9 billion of those funds had been wasted on various school projects in NSW and Victoria. The taskforce said NSW public schools were charged on average $A3448 per square metre for all classrooms, halls and libraries built, compared with $A2707 per sq m for similar projects in private Catholic schools, a 27% premium.

It also found defects in building template designs at 175 schools which created safety risks from sharp metal edges and problems with storm-water drainage that led to flooding.

Economic freedom and quality institutions

In 2016, Danish economist Christian Bjørnskov analysed 212 crises in 175 countries between 1993-2010. He empirically judged the effects of economic freedom (which, for example, relates to the quality of institutions, trust in the rule of law and relative ease of doing business) on crisis risk, duration, severity and time to recovery. His results showed no connection between the risk of a crisis and overall economic freedom nor any the index's four pillars. How long a crisis lasts, defined as the number of consecutive years of negative economic growth, was also unrelated to economic freedom.

However, the size of the economic contraction during crises was strongly negatively associated with the initial level of economic freedom. In other words, greater economic freedom means a crisis will be less painful and speeds up any recovery back to pre-crisis GDP levels. Both effects were predominantly due to differences in business and monetary freedom, not in government spending, rule of law or product market regulations.

Bjørnskov's interpretation of his findings is that as a crisis hits an economy, a substantial share of a country's resources may become idle creating profit opportunities for entrepreneurs. However, whether resource reallocation happens (and at what speed) depends on the overarching regulatory framework and if it can be efficiently and transparently enforced.

For instance, licensing requirements and other burdensome business regulations prevent entrepreneurs from seizing opportunities. A 2016 paper by Simon Greenwood and Andrea Menclova suggests that 28% of Kiwi jobs are affected by occupational regulation. Unstable monetary policy and inflationary controls make it hard to form price expectations which increases uncertainty and reduces investment. It also becomes risky and expensive to hire new employees when labour market regulations are too stringent. New Zealand studies on the relationship between resource reallocation and labour productivity growth during past recessions, using solid company data, are consistent with Bjørnskov's results. In particular, firm turnover and resource reallocation between Kiwi firms boost productivity. Similarly, OECD simulations suggest a gradual alignment of product and labour market regulations to best-practice lifts aggregate labour productivity levels by several percent over a decade.

New Zealand can again take heart from these results. In 2020, this country ranked third out of 180 countries in the Heritage Foundation's index of economic freedom. This does not mean, however, the Government has more room for new regulations to survive the Covid-19 crisis. On the contrary, it should seek opportunities to improve its institutions and cut away regulations. Bjørnskov points out that countries with higher initial levels of economic freedom tend to increase that freedom in the first two years of a crisis.

Conclusion

New Zealand's economic policy response to the Covid-19 pandemic has so far rightly focussed on maintaining the economy's productive capacity by supporting firms, workers and the relationships between them. Any future policy response must not jeopardise the country's long-term growth prospects by maintaining economic freedom and relatively low levels of public debt.

Budget 2020 will likely increase Government spending to help counter the worst effects of the crisis. It is crucial that New Zealand's strong institutions that champion fiscal responsibility, sound monetary policy, the rule of law and predictable regulatory outcomes are maintained. Cabinet's recent decision to suspend the Regulatory Impact Analysis (RIA) framework due to Covid-19 is concerning and may undermine proper evaluation of some of the Government's largest looming decisions. New spending and regulatory initiatives should be of high quality and pass appropriate cost-benefit thresholds. The Government should also outline a credible path for debt levels to return to sustainable levels.