

ESSAY

HOW COVID-19 AND CLIMATE CHANGE CHALLENGE ECONOMIC ASSUMPTIONS

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Classification is a necessary aspect of public administration, but our regular contributor Ian McAuley explains why false dichotomies – such as the presumed trade-off between health and economic activity during the pandemic – and outdated categories of economic capital can have distorting and deleterious results.

The COVID-19 pandemic has been economically disruptive in two ways. First, its direct consequences have been a seven million global death toll, a setback to worldwide economic growth, and a reversal of progress in eliminating poverty. These are covered in reports by the World Health Organization, the International Monetary Fund and other agencies.

Second, the pandemic has also exposed fault lines in economic systems, addressed in this essay. In countries where public policy prioritised 'the economy' over public health, because of interdependence between a nation's health and its economic performance, there were setbacks in both domains: any assumed trade-off between 'health' and 'the economy' was revealed as a false dichotomy. As economic philosopher Karl Polanyi wrote in 1944, 'The economy is subsidiary to society: it does not sit alongside society'.¹

The fragility of global supply lines and carefully calibrated Just In Time systems was exposed in goods ranging from crucial microelectronic circuits through to shipping containers. As the deadlines of the pandemic became evident, many countries took

1. Polanyi, 1944

measures to suppress it, revealing the dependence of economies on workers with basic skills, such as drivers and cleaners. Big conurbations, once seen as hubs of economic dynamism, became places to avoid, as mobile professionals retreated to the suburbs or rural settlements.

The counter-cyclical monetary and fiscal measures that governments usually apply to deal with recessions worked in a gross sense in avoiding a 1930s-type catastrophe, but they had perverse and unexpected consequences. In a typical business-cycle recession, low-interest rates should stimulate private investment and easy fiscal policy would be directed to nation-building projects or catching up on infrastructure development.

This was no business-cycle recession, however, where businesses and governments could make a reasonable prediction about the economy's recovery and invest with confidence. Until effective vaccines were developed, there was little sense in making plans for the future. Rational decision-makers in the private and public sectors can cope with business cycles for which risks can be reasonably and rationally quantified, but this recession was not amenable to statistical calculations of risk: it was a situation of uncertainty.

Had this recession been similar to past recessions, all the monetary and fiscal stimulus would have given a counter-cyclical spur to the real economy. Much of the stimulus, however, found its way into bidding up the price of existing assets: the US stock market peaked in January 2022, and in many Western countries house prices, already inflated before the recession, reached even higher levels. Already well-off households saw their balance sheets improve, while those with no financial buffers went backwards. As Thomas Piketty demonstrated, widening wealth inequality is a natural tendency of capitalism,² and inadvertently, policy responses to COVID-19 worsened that inequality.

Public spending saw the accumulation of vast levels of government debt, but without anything much on the public asset side of the balance sheet. There has been no 'New Deal' response to this recession.

As economies emerged from the pandemic, labour shortages emerged, but real wages did not rise. Much of the fiscal and monetary stimulus has made its way into profits rather than wages. That growth in corporate profits has been uneven, however: many businesses that had lost sales, from coffee shops to airlines, also became highly indebted during the long period of low interest rates.

Concerned with inflation, central banks have been raising interest rates to rein in excess liquidity. Governments in Western countries are pursuing conservative fiscal policies while dealing with normal budgetary demands for healthcare and income support for ageing populations. They also have the burden of accumulated government debt, incurring higher interest rates as central banks have tightened monetary settings.

In many countries, as a result of fiscal austerity, incomes for public sector workers in health care, education, aged care and other services have fallen behind the incomes of their private sector counterparts, even as COVID-19 made extra demands on services. As these human services are intrinsically labour-intensive, they become more costly than other goods and services, where productivity improvements have reduced their real costs as time passes. Moreover, they are bound to make more demands on public budgets because they are in the public sector.³ An associated outcome is that gender pay issues have returned to the forefront of economic debates because the workforces in these industries are mainly female.

These have been the challenges posed by the COVID-19 recession: the pandemic has exposed fault lines in countries' economic arrangements.

2. Piketty, 2014

3. Baumol, 2012

Economic theories previously considered as verities have been revealed as conditional on neoliberalism's assumptions.⁴

In particular, much of 'rational actor theory' becomes irrelevant when people are faced with a situation looming as an existential threat on the scale of the Justinian Plague,⁵ that requires mobilisation of community cooperation and yielding to the paternalistic hand of government. Neoliberalism, already dealt a blow during the 2008 global financial crisis, has become even more unfashionable, but no coherent economic theory is waiting to take its place.

As countries emerged from COVID-19, the other challenge, not easily handled in existing patterns of economic behaviour, has been the need to cope with climate change. That involves reducing nations' contribution to greenhouse gases, and building national resilience to its effects. On these counts, Australia has pressing needs: it must reduce its greenhouse gas emissions, which have been high in comparison with other industrialised countries; it has to cope with shrinking world demand for coal, and in the longer term less demand for gas, which have comprised more than half its exports; and it has to deal with increasing natural catastrophes and the need to shift some of its zones of agricultural production and settlement.

Whatever economic theories emerge in the coming years, economic reconstruction following COVID-19, and the need for transformative investments to cope with climate change, will demand economic resources. Investors will have to accept more modest returns in countries that have enjoyed high and easy profits from resource extraction, particularly 'settler societies' such as Australia. The industrial transition to cope with climate change should create many new investments and jobs, but profits and dividends

will not flow for some time. Countries that have tried to get by on low taxes, such as Australia, will have to raise taxes just to sustain present levels of public services and raise taxes further to fund the public assets needed for a transformed industrial structure.

In terms of public policy, there is no easy 'Pareto' solution – a solution in which no one needs to bear any direct cost – on the table. There will be benefits in dealing with climate change and re-investing in the public sector, but these benefits are down the track, and many are in terms of avoiding losses. As behavioural economics confirms, delayed gratification is generally unappealing and loss-avoidance is hard for people to conceptualise (which is why public health had such a hard time competing for resources until an obvious threat loomed over the horizon).

RE-THINKING PRODUCTIVITY AND CAPITAL

One uncontentious response to these challenges is that there will be less sacrifice if productivity can be improved. To quote Paul Krugman's aphorism, 'Productivity isn't everything, but in the long run, it's almost everything'. In 'advanced' economies, including Australia, productivity growth, particularly labour productivity, has been slowing in this century.⁶

Increasing productivity is a necessary condition for restoring wage growth, but it is not a sufficient condition. If market-based capitalism is to retain its social licence and sustain a well-paid workforce buying its products, the benefits of productivity-improving investment must be distributed in a way that people accept as fair.

If labour productivity is to rise, there must be investment in capital. This is where re-thinking is needed for, as former Australian Science Minister

4. See, for example, Andrew et al., 2020

5. The plague of Justinian was first recorded major outbreak of the first plague pandemic in Europe and the Mediterranean.

6. World Bank, 2021

Barry Jones said, when we think of 'capital', we imagine something that hurts when you drop it on your toes. No doubt Karl Marx was bound by the same constraint, as was David Ricardo, who developed a classification of factors of production – land, labour and capital. In an economic system comprising large landowners, a plentiful supply of minimally skilled workers, and considerable physical capital such as factories and ships, these factors made a great deal of sense, but later attempts to trace economic outputs to distinct factors of production have led economists down confusing paths, littered with vague definitions and category errors.⁷ Economies are interactively complex systems, not easily understood through reductionist simplifications. 'Capital' is one such simplification.

Had Marx or Ricardo walked into a business in the 1960s and seen a computer in operation, they would have been amazed by its analytical power, but they would have recognised the industrial setup with many people employed keeping the machine running. Labour was an adjunct to capital as it had been in their times. Had they come back sixty years later, however, and met an engineer with a hand-held device, their economic model would have been overturned. In many industries, labour has become the scarce factor, while the cost of physical capital has tumbled. The labour shortages manifested in the post-COVID recovery have highlighted this change.

Also, the nature of 'capital' has changed. It would be hard enough to convince Marx and Ricardo that something as light as a cellphone is productive capital, let alone many less physical forms of capital, including computer code, customer lists and intellectual property rights, the value of which

has to be maintained through data protection, licences, patents and copyright. There were such protections in the 18th and 19th centuries, but the main barrier to ownership of capital was the cost of producing physical equipment.

The capital that makes engineers with hand-held devices productive is their human capital, mainly their education and accumulated skills. If there is a shortage of such people, they may extract some surplus above compensation for investment in university fees and years of forgone income. Human capital has probably accumulated from their associations, friendships and upbringing in a home where learning was encouraged. The American Marxist Jerry Muller would identify them as 'capitalists' because they own valuable capital and may extract surplus value from that capital.⁸ By contrast, many still have little to offer, other than commodified labour, or basic generic skills, either on payrolls or as micro businesses in the gig economy.

This insight may seem self-evident: policymakers have talked about human capital for many years,⁹ but it is not incorporated into public accounting and budgeting, which classify outlays on education and training as recurrent rather than capital outlays.

Another form of capital that is even harder to fit into the traditional classification of factors of production is social capital. The World Bank offers a definition aligning with most policymakers' understanding:

The social capital of a society includes the institutions, the relationships, the attitudes and values that govern interactions among people and contribute to economic and social development. Social capital, however, is not

7. Marx conflated capital and labour into one factor, labour, considering capital equipment as the accumulation of labour inputs. Economists broadened the concept of land to incorporate all natural resources. Some added 'finance' as another factor although it is more easily seen as a facilitator of factors rather than a factor in itself. And it has become fashionable to add 'entrepreneurship' as a fourth factor, even though it is embodied in people, and can be considered as labour.

8. Muller, 2013

9. The term came into common use from Gary Becker's work *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education* (Becker, 1975)

simply the sum of institutions which underpin society, it is also the glue that holds them together. It includes the shared values and rules for social conduct expressed in personal relationships, trust, and a common sense of 'civic' responsibility, that makes society more than just a collection of individuals.¹⁰

Social capital is rightly described as 'capital' in that it yields ongoing benefits in building and sustaining trusting relationships, thereby reducing transaction costs, promoting knowledge sharing and increasing productivity.¹¹

Social capital has public good properties in that it is generally non-excludable (non-contributors enjoy its benefits) and non-rival (it is not depleted by people enjoying its benefits). Although it may manifest in private markets through more straightforward contracts and less litigation, it will not automatically arise in private markets. Instead, it has to be nurtured and sustained through public policy.

In that regard, trust in government is a critical component of social capital. If people trust government to act with fairness and in the public interest, they are more likely to support well-considered economic policies and pay taxes to sustain public services that strengthen the economy and help distribute the benefits of economic activity more fairly.

CLASSIFICATION AND ACCOUNTING

Regarding classification, it is hard to force-fit human capital or social capital into traditional notions of 'capital'. This is more than a semantic point. Classifications have consequences because they influence the way public policy develops.

Classification of public investments in human and social capital – and for that matter, in preserving or remediating environmental capital – as 'recurrent' in public accounting has consequences. When governments are concerned with reducing accumulated public debt, and when there is a political focus on fiscal deficits, it is harder for a government to justify outlays on human and social capital than it would be if they were classified as 'capital' and presented as assets on the government balance sheet.

Maybe it is not feasible to make such a change in classification because it would clash with the basic concepts of accounting – conservatism, money measurement and materiality – which give accounting reports a certain consistency. If that constraint must be accepted, governments need to shift their reporting emphasis from figures such as budgetary cash surpluses and deficits towards a public balance sheet approach, where that balance sheet includes much that is not amenable to precise valuation. That would mean more emphasis on economic policy and less on fiscal policy in public debates.¹²

Classification is a necessary aspect of public administration. When it is based on false categorisation, however, as with the distinction between 'health' and 'the economy', or is based on 200-year-old definitions, as with a physical classification of 'capital', it can lead to poor policy outcomes. Reductionism is an aid to public policy, but its classifications should not drive public policy.¹³ Policymakers need to look at society in ecological terms, as a system with inherently complex interrelationships and emergent properties, rather than in the reductionist way underpinning current classification systems.

10. World Bank, 1988

11. Productivity Commission, 2003

12. McAuley, 2016

13. Scott, 1998

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