Written evidence submitted by the Adam Smith Institute

Free markets, limited government, democracy and individual rights have delivered immense human prosperity. They have raised our standard of living, provided social mobility and protected human freedom. But some are now, particularly in response to the Covid-19 crisis, calling for a new settlement. They claim the crisis has shown the need for a bigger state and business that demotes profit.

These claims are nothing new. Many were suggesting the same prior to the crisis. Nevertheless, this crisis – combined with the public's declining faith in both political parties and free market capitalism – could be hijacked to reshape society in an unconstructive manner.

If this is to be avoided, we must learn the right lessons, about state capacity and the role of business, from Covid-19. These lessons are the opposite of what has often been suggested. If governments and businesses are to regain public faith, and improve their effectiveness, they must focus on their traditional competencies.

Many governments, which have expanded their role in recent decades, struggled to provide effective pandemic response: they failed to respond in a timely manner and restricted testing that allowed the virus to spread. Meanwhile, businesses, albeit with challenges and state-support, have largely responded successfully to immense challenges.

The crisis is revealing and should help refocus attention. The state failure evident in response to Covid-19 undermines the case for a greater central role in the direction of the economy. The state must, to regain public trust, focus on effectively delivering traditional demands for essential public services and safety.

Businesses must be able to dynamically respond to its new circumstances when the economy is unfrozen. Removing barriers to businesses will be essential. This is not the time for policy experimentation or a new model of capitalism, like some have brazenly claimed. Excessively directing the economy, and pursuing policies that are either unproven or debunked, risks prolonging the downturn.

It is important to remember businesses themselves are social goods: they create useful products and provide people with salaries, as well as pay their taxes which will be necessary to fund COVID-19 related debt for many years to come. The goal must be simple: jobs and growth. We need policies that deliver economic growth and jobs to the millions of people who are being sacked.

innovation and productivity growth has very little to do with which firms the state happens to support. In fact, the opposite can eventuate. The offer by the state of support to firms encourages 'rent seeking': entrepreneurs put effort into seeking handouts rather than, let's say, introducing a valuable new consumer product or finding cost savings in an industrial process.[1]

These rent seeking entrepreneurs may also spend their time campaigning for regulation that undermines their competitors – like the owner of a water-driven mill in the 12th century that won prohibitions against mills driven by animals or humans. The rent seeking damages the economy since rather than expanding the economic pie these capable individuals instead spend their time extracting value from an ever-small pie.

Bureaucrats struggle to separate the truly deserving from these rent seekers. Firstly, because bureaucrats lack the expertise and the knowledge, which is dispersed among market actors, to determine what are the most productive ventures. Secondly, the political process that decides who receives grants is inevitably influenced by lobbying, meaning picking favourites (like OneWeb) and not others independent of the objective value of the businesses. This is an inherent problem the larger the state becomes and the more it becomes involved in directing the private sector. American investor Joe Lonsdale has explained how "expansive modern government presents private corporations with thousands of new opportunities to twist the coercive power of the state to favor their private interests.

So when the state offers handouts it leads to "subsidy entrepreneurs," according to academics Anders Gustafsson, Patrik Gustavsson Tingvall & Daniel Halvarsson: "highly productive entrepreneurs abstain from seeking grants, moderately productive firms allocate a share of their effort to grant seeking, and low-productivity firms allocate most resources to seeking grants". They find, using data from Sweden's three largest grant distributing agencies, that less productive firms are the ones most likely to receive state handouts. In other words, state handouts can keep unproductive businesses alive, lowering overall levels of prosperity.

If nothing else, there's also little consideration whether taxpayers are getting value for money. The National Audit Office (NAO) has been scathing of the UK Government's handling of the £17 billion and 107 business support schemes. They found, from a sample of ten schemes, that this spending "lacked measurable objectives from the outset or evaluations of their impact to know if they are providing the most value or if they should be discontinued. None fulfilled all the basic requirements, considering the costs and benefits of alternative policy options, to justify setting up a scheme. None were correctly monitored. Six of the ten schemes analysed lacked even an *objective*, let along an evaluation of the costs and benefits. They also found many schemes were over allocated funds and had limited business interest. The NAO found one case of proper evaluation: Innovate UK's flagship 'Smart funding scheme' which offers grants of up to £25 million for research and development to start-ups and SMEs. The evaluation of the 'Smart funding scheme' concluded that there were no differences between businesses awarded funding and those not awarded funding. (Nevertheless, the Government's summary page of the evaluation claims the scheme had impact, omitting the lack of difference between companies that did and did not receive funding.[2]) The support scheme continues despite the lack of value for taxpayers.

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[1] William J. Baumol, "Entrepreneurship: Productive, Unproductive, and Destructive," *Journal of Business Venturing* 11, no. 1 (January 1, 1996): 3–22, https://doi.org/10.1016/0883-9026(94)00014-X.

Overall the NAO concluded that, because of a lack of analysis, “the Department cannot know if its business support is providing value for money.” An earlier NAO analysis of venture capital support to small business also found a lack of clear objectives, poor financial management, and a lack of demonstration of value for money. Similarly, the NAO concluded, in a separate report into the British Business Bank, which provides state-backed loans to small to medium businesses, that “there is limited information on the cost-effectiveness of its activities”.

Zombie companies

The direct state-support for specific businesses is not all that is causing economic distortions, creating vulnerabilities and undermining longer-run economic growth. Under the guise of smoothing markets, central banks have repeatedly responded to crises by lowering interest rates and, when this was no longer possible, purchasing hundreds of billions of bonds known as quantitative easing (QE). As discussed, state support as an ‘insurer of last resort’ against an unexpected pandemic was justified. This ensured companies that were otherwise productive from collapsing. Early in the crisis this was supported by central banks entering bond markets to ensure borrowing costs remained low for governments and preventing a broader market crash. More generally, looser monetary policy during a recession is an unobjectionable tool to limit economic damage.

This inference in financial markets, however, is not without downsides. Firstly, it has huge implications for inequality: asset owners are huge beneficiaries. This drives intergenerational inequality, that in turn feeds disillusionment with the free market system – the notion that the older, asset-rich are unfairly manipulating the value of their existing assets at the relative loss to the younger asset-free. It has been noted that despite the chaotic state of the broader economy during 2020, asset prices and the stock market have remained extremely high, likely because of “near zero” interest rates.

Secondly, central bankers have likely been responsible for a mammoth misallocation of investment over recent decades, contributing to the productivity crisis. “Global monetary instability lures astonishing amounts of capital into speculative bets on exchange-rate movements and financial markets rather than productive capital equipment or research and development for businesses,” Joseph Sternberg of the Wall Street Journal writes. This boosts the financial sector, and unproductive industries like production, at the cost of broader economic productivity.

Finally, on a micro level, plentifical credit keeps alive larger and less productive companies that have direct access to low-cost bonds – undermining competitive pressures from new firms that are key to economic growth. This has been called the ‘zombie companies’ phenomenon. These

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[2] “Smart Funding: Assessment of Impact and Evaluation of Processes,” GOV.UK (Innovate UK, October 13, 2015), https://www.gov.uk/government/publications/smart-funding-assessment-of-impact-and-evaluation-of-processes.

are businesses that are incapable of making enough profit to cover their debt for several years, but survive because of extremely low interest rates. They provide limited returns and economic value, but prevent skilled individuals and capital being put to their best use, undermining dynamism, investment and productivity. These companies have likely contributed to lacklustre productivity growth, depressing prices and increasing wages, discouraging new entries and innovations.

A 2017 study of OECD countries found that "a higher share of industry capital sunk in zombie firms is associated with lower investment and employment growth of the typical non-zombie firm and less productivity-enhancing capital reallocation." There is evidence that zombie firms have contributed to Japan's stagnation since the 1990s. A study that investigated industry and firm level data from Japan found that "productivity growth is low in industries reputed to have heavy concentrations of zombie firms".

A study by KPMG concluded, in May 2019, that 8% of private companies in the United Kingdom showed zombie-like symptoms – with the most in the energy, automotive and utilities sectors.[3] A study by BIS found the number of zombie firms experiencing an upward shift during downturns that does not fully reverse during recoveries, in no small part because of low interest rates. [4] The same study confirms zombie firms are less productive and crowd out investment and employment in more productive firms. There is early evidence that Zombie companies have only multiplied because of state-support during the Covid-19 crisis – allowed to fester by huge quantities of quantitative easing and state bailouts. There is evidence of a lower rate of insolvency notices in April to June 2020 than in the previous year, after an uptick in March, indicating many firms are holding on that might not be viable in the longer run.

Big government undermines economic growth

The zombie company phenomenon speaks to the broader danger that larger government undermines economic growth. Larger governments, that must be funded with higher taxes or more debt, crowd out productive private sector enterprises. They also distort incentives, as the previous section on subsidy entrepreneurs showed. A 2011 working paper by researchers at the European Central Bank found a "significant negative effect" of larger government on per capita GDP growth in 108 countries over four decades.[5] "Interestingly, government consumption is consistently detrimental to output growth irrespective of the country sample considered

[3] https://home.kpmg/uk/en/home/media/press-releases/2019/05automobile,%20utilities%20and%20energy%20sectorszombies-are-a-major-drag-on-the-uk-economy-kpmg-analysis.html
[4] Banerjee and Hofmann, "The Rise of Zombie Firms."

[5] Antonio Afonso and João Tovar Jalles, "Economic Performance and Government Size," SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, October 28, 2011), https://papers.ssrn.com/abstract=1950570.

(OECD, emerging and developing countries)," the authors find. They note the risk of state "monopolization of the allocation of resources and other important economic decisions".

Ruchir Sharma, an emerging market economist at Morgan Stanley, explains well-intentioned efforts has done longer term damage:

> "As governments stepped in to do whatever it took to eliminate recessions, downturns no longer purged the economy of inefficient companies, and recoveries have grown weaker and weaker, with lower productivity growth." [6]

The Royal Statistical Society has declared the United Kingdom's statistic of the decade to be 0.3%: the average annual increase in UK productivity in the decade since the financial crisis.[7] This marks the lowest annual increase in output since the early 1800s. Annual output, before the huge decrease caused by the Covid-19 pandemic, would be one-fifth higher if it grew at the pre-2008 trend. Historically economic growth was driven by technological innovation that shaped the Industrial Revolution and British economic growth.[8] Sharma focuses on the lack of appetite for risk-taking and failure, the ultimate driver of economic growth:

> "Without entrepreneurial risk and creative destruction, capitalism doesn't work. Disruption and regeneration, the heart of the system, grind to a halt. The deadwood never falls from the tree. The green shoots are nipped in the bud."

Some of the well-intentioned Covid-19 support packages are counterproductive: keeping alive firms that are no longer needed. It is necessary to clear out the dead wood so human efforts can be reallocated to its best use. Governments lack the ability to identify which firms can be turned around. While during the Covid-19 crisis itself it was necessary to support some businesses, to put them on life support to weather the unexpected event, ultimately it will be the role for the private sector to decide which companies will survive. If the state steps in excessively it risks creating another lost decade of growth.

Does the Government have the right mix of policies and a coherent strategy to promote long-term productivity growth and create new high-quality jobs?

Short-termist regulations designed to protect jobs from competition risk economic stagnation and mass retraining schemes rarely live up to their lofty promises. As we attempt to return to a

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[6] Ruchir Sharma, "The Rescues Ruining Capitalism," The Wall Street Journal, July 24, 2020, http://wsj.com/articles/the-rescues-ruining-capitalism-11595603720

[7] "RSS announces Statistics of the Decade," Royal Statistical Society, December 23, 2019, https://www.statslife.org.uk/news/4398-rss-announces-statistics-of-the-decade

[8] Jakob B. Madsen, James B. Ang, and Rajabrata Banerjee, "Four Centuries of British Economic Growth: The Roles of Technology and Population," *Journal of Economic Growth* 15, no. 4 (December 1, 2010): 263–90, https://doi.org/10.1007/s10887-010-9057-7.

fully operational economy, the Government must shift from “freezing” people in their existing jobs to ensuring they are where they are most wanted.

Retaining a worker that is not adding value to a company on a company’s books is financially unsustainable for a firm, economically inefficient if multiple firms act in the same way, and actively reduces the ability of the worker in question to progress or have an impression of earned worth in a job. Japan’s strict labour laws result in firms instituting “chasing-out” rooms for employees that didn’t take early retirement options — places where individuals would be sent with no responsibilities but also no corresponding possibility of recognition of work. In the United States public school system, a similar fate befell teachers that were falling well below expectations, as they were sent to “rubber rooms” until they chose to leave the profession. Workers stuck in these purgatories feel that they are failed by their companies but more often than not they are failed by the law.

Is the Government doing enough to encourage corporate investment?

The Government’s introduction of the factory ‘super deduction’ is welcome. The Adam Smith Institute estimated at 100% full expensing would be worth over £2,214 per worker; going beyond that is a bold move to help the private sector build the recovery. It will benefit most those areas that have been left behind in recent decades.

The Chancellor has also suggested that he believes March’s measures to be sufficient in returning public finances to a stable footing. If he is correct, the Treasury should begin to consider restructuring the tax system to boost the slow growth that has plagued the economy since the financial crisis. This would mean distinguishing between an increase in the stock of debt, to pay for the pandemic, and a structural deficit, like the permanent unsustainable spending that needed to be tackled after 2010.

Going for immediate tax revenue neutrality and boosting the rate of growth will “pay” off for the state coffers in the long run. With a forecast of 7.25 per cent growth this year, the Chancellor would do well to use the figure as a baseline commitment to an equal or higher annual growth rate.

The Government should also consider raising the NI threshold. Employees currently pay National Insurance at the following rates on their earnings. For the first £7,605 they pay 0 percent, for the next £34,870 a rate of 12 percent is levied, and a further 2 percent is levied for amounts over £42,475. Employers pay 13.8 percent on every pound the employee earns over £7,488 with no cap.

If the government wants to encourage firms to hire they should immediately raise the bottom threshold for employer’s National Insurance to £12,500.

Conclusion: Remaking government and business

The year of 2020 will forever be known as the year of "unprecedented". But in other ways, we are facing a repeat of previous debates about the role of government and the role of business. These debates have been happening for decades, if not for centuries, in response to changing circumstances.

Ultimately, the government needs to protect competition and free markets. In practice, following the crisis, governments need to shrink so the private sector can get back to allocating resources to where they are most productive.

The economy is dependent on a complex web of billions of relationships; it is not some system that can be directed from above. For far too long damaging taxes and strangling red tape has held back the ability of businesses to create prosperity. The growing size and scope of the state have wasted taxpayer money, misdirected businesses, incentivised cronyism, held back competition, and limited human potential. This must come to an end. An agenda focused on reducing regulatory barriers to entry to stimulate job-creation and innovation.[9]

There is also a strong case for remaking government, to make it more responsive, capable of responding and local knowledge and less centralised. This could ensure better delivery of services like police, roads, public health and education. If a business tries to do what the government ought to do, it won't be successful. But when the government takes on the role of an investor (picking the winners) or as a business (we know what consumers want), they will make mistakes. This would enable greater learning from experiments.

A new model will be necessary to recover from this crisis and address future challenges — as well as repaying the trillions of dollars of new debt and funding the growing pressures on public services. By focusing on their fields of competence, both the state and business can ensure broader prosperity.

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[9] Simeon Djankov et al., "The Regulation of Entry," *The Quarterly Journal of Economics* 117, no. 1 (2002): 1–37.