POLICY Brief

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Beware of Moral Hazard in COVID-19 Policy Responses

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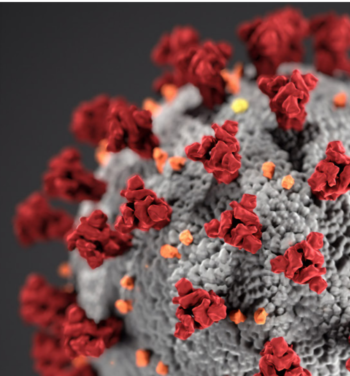
The global financial crisis of 2008-09 confronted policy makers with the age-old policy dilemma of moral hazard. Some large banks in the United States and Europe had bet big, and badly, on subprime mortgages and were at danger of failing because of their excessive and careless risk taking. Given their massive size and interconnectedness, their collapse would create widespread disruption in the financial system and possibly trigger a depression. However, bailing them out with public money would give them and other large financial institutions a sense of comfort that if they ever got into trouble, government would be there to backstop them and their reckless behaviour. In responding to this crisis, governments faced the challenge of moral hazard—the economic concept that an entity protected in some way from risk will behave differently than if it didn't have that protection.

As it turned out, U.S. and U.K. financial authorities dealt with this dilemma, not perfectly but at least deliberately, in the design of their interventions to protect the financial system. And post crisis policy frameworks were structured in part to respond to moral hazard risks. One noteworthy example was the creation of a new category of "systemically important financial institutions", explicitly judged "too big to fail", but then as a consequence made subject to much tighter regulation and higher minimum capital buffers.

Fast forward to the global COVID-19 pandemic, with a lens on how Canada is responding to this dual health and economic crisis. Within weeks, the Canadian economy and society were virtually shut down to contain the spread of the virus. To address impacts on employment, incomes, and the balance sheets of households and businesses, the Bank of Canada and the Government of Canada responded with massive stimulus. The Bank cut interest rates to record lows and injected extraordinary liquidity into the financial system through

COVID-19 SERIES: FROM CRISIS TO RECOVERY

This issue of *JSGS Policy Brief* is part of a series dedicated to exploring and providing evidence-based analysis, policy ideas, recommendations and research conclusions on the various dimensions of the pandemic, as it relates here in Canada and internationally.



quantitative easing. The Government delivered income and liquidity support on an unprecedented scale through a raft of new and existing programs to Canadians impacted by the pandemic.

So, is moral hazard a risk in how the government intervenes in this crisis? After all, no recipient of aid contributed to the cause of the crisis, unlike in 2008-09, and any assistance to weather the crisis is unlikely to influence behaviour in a way that would contribute to future pandemics. But moral hazard is about unintended incentives and impacts on expectations and behaviours, not just the intended ones. The economic policy response to COVID-19 is no exception, no matter how well founded the intent to deliver emergency relief.

We examine three potential manifestations of moral hazard in the emergency policy responses of government to this crisis that warrant early attention:

- An expectation that the Government can insure all Canadians against all risks all the time.
- The nationalization of private debt through an extension of access to credit to businesses into financial bail-outs.
- An expansion of public borrowing at the expense of succeeding generations of Canadians.

Moral hazard in public policy interventions is always a risk, and containing it can entail tough choices. Yet it must be taken into account in order to minimize the long-term costs of any crisis and to drive behaviours toward a stronger recovery and greater resilience.

The Government has your back—but when is that assurance too much insurance

The Government of Canada is rightly given credit for moving early in the COVID-19 crisis to contain the losses of income of workers and households from the effects of the pandemic. The Prime Minister has stated through a series of announcements that "the government has your back."

The central instrument of income support has been the Canada Emergency Relief Benefit (CERB) that pays $500 per week to employed or self-employed Canadians who have been sidelined by sickness or by loss of activity. The CERB was implemented as an emergency measure when it became apparent that the EI program, given its design, eligibility rules, and administration would not be capable of delivering adequate relief. The broad eligibility and simplicity of the CERB allowed efficient delivery under the tax system to all workers affected by the crisis, whether or not they were eligible for EI.

The moral hazard arises with the design of the assistance and its quantum—a probable case of too much of a good thing. As indicated in the government's July 8, 2020 Economic and Fiscal Snapshot (see Chart 2.17 in the Snapshot), in the first half of 2020 the CERB and other direct payments (including one-time supplements to the Goods and Services Tax Credit and the Canada Child Benefit) transferred $65.3 billion to Canadian households whereas the employment income loss due to the pandemic was considerably less at $44.6 billion.

In short, Canadians in aggregate have received an insurance settlement for the crisis to date that is nearly 50 per cent greater than their loss. The immediate effect for the economy and for households is unambiguously positive. However, there are longer-term vulnerabilities related to the simple principle that insurance in commercial markets is never offered for more than the value of potential losses.

Sustained lockdowns are economically and fiscally untenable. The average of private sector forecasts presented in the Snapshot has Canada's real GDP dropping by 6.8 per cent in 2020 even with a partial recovery over the summer and fall. The government projects that the fiscal deficit in 2020-21 will reach a post-war high of 15.9 per cent of GDP. Net federal debt will grow from 31 to 49 per cent of GDP. And gross federal debt will be over 100% of GDP.

Canada, like other countries, needs to adjust to live and to work with the pandemic risk that may last for many months before a vaccine is widely available. Clearly, the risk to public health in the workplace must be effectively managed through testing, tracing, mask wearing and workplace redesign. At the same time, a priority of economic policy must be to ensure that there are no unintended impediments to getting Canadians back to work and earning employment income.

But the CERB is doing just that. Many Canadians personally have no strong economic incentive to return to work because of the design of the emergency income support measures. In short, their loss of income to date has been more than compensated. The CERB is slightly more generous than full-time employment at the minimum wage. The government corrected the original design mid-course by allowing recipients to earn income of up to $1000 per month, without losing the benefit, but this creates a new "wall" at that level of income. The government advises that recipients should be seeking work opportunities or returning to work when their employer makes such requests, but there is no mechanism to enforce this. With this CERB income option, also taking into account fear of contagion, or challenges in finding affordable child care, Canadians may choose quite rationally to stay home rather than return to work

Moral hazard may in fact be more detrimental to individuals' own interest, as well as the collective economy, than is immediately apparent. For some workers in some sectors, the jobs of before will not return. For younger workers, early on-the-job experience and contact with colleagues in the workplace is foregone. Thus, human capital may be eroding and nothing in the design of the CERB is encouraging enrollment in training programs, or enabling transition to new job opportunities. The longer the pandemic intrudes, the greater will be the structural impacts, and the slower a return to a more normal economy.

A false sense of security can also arise to the extent that workers believe that government can and will insure all Canadians against all risks all the time. Indeed, some see the CERB as morphing seamlessly into a guaranteed minimum income without the wider structural economic and social policy reforms that will have to accompany a necessary review of the social protection system.

What should be done to alleviate this moral hazard in a well-

meaning program? The design and incentive structure for the CERB or its successor have to encourage a return to work where this can be done within a sound occupational health and safety environment. Realistically, the level of benefits has to be reduced. Where jobs are not available, the effort must turn to aligning skills and competencies to the evolving needs of the labor market, in both the private and public sectors. In short, assistance must shift from supporting consumption to aiding the recovery and building productive capacity.

Credit and aid to businesses is flowing—but when does the flow become a flood

The COVID-19 crisis is not your typical recession. It has come on much faster and deeper than anything in our postwar experience, has affected services more than industry and has exhibited remarkable variations in its impacts across sectors. For example, as of June 30, 80 per cent of small businesses in the construction sector were fully open, whereas in the hospitality sector, that proportion was only 30 per cent. Macroeconomic stabilization in the form of lower interest rates is insufficient to mitigate such impacts. Without the delivery of targeted aid, many businesses would be forced to shut down permanently, exacerbating the longer-term impacts of the crisis on long term economic capacity.

This has forced the government into exceptional instruments of economic assistance. The Canada Emergency Wage Subsidy (CEWS) was introduced to pay up to 75 per cent of wages where employers (of all sizes) lost 30 per cent or more of their revenue due to COVID-19. The measure has now been extended to December 31 under a design enabling more firms to participate. The government also implemented a range of financing mechanisms, including through the Export Development Corporation (EDC) and the Business Development Corporation (BDC), to supplement and backstop sources of credit in the market and create a bridge for firms to the other side of the crisis. While the programs targeted mostly small and medium-sized firms, supports were also made available to mid-sized, and then larger firms, but with tighter conditions.

The programs have shifted significant business cost and risk to the public sector. The CEWS is projected to cost $82.3 billion. The credit support programs represent a commitment to date of over $86 billion, some of which is forgivable, all of which requires Government of Canada borrowing and represents an added risk exposure to the fiscal framework. This is in addition to financing and risk already assumed by the government of some $60 billion to allow businesses of all sizes to defer income tax payments and the remittance of sales taxes and customs duties.

Where, then, is the moral hazard? The government's policy prescription described above has side-effects, primarily in the form of more debt, at a time when Canadian households and businesses had worrisome debt levels before the pandemic struck. And, like many strong medicines, the longer you take it the greater its after-effects and the higher the chance of addiction. With most forecasters predicting a recovery that will be slow and bumpy, the moral hazard risk is an extension from temporary to indefinite assistance, and from granting loans to forgiving debt –in effect, a nationalization of private debt.

Government emergency support, even with appropriate criteria and due diligence, will become more poorly correlated with economic performance the longer it continues. Firms with stronger balance sheets, more resilient business models, and solid foundations for growth will have increasingly less need for government liquidity support than those that were already highly levered, with narrow business margins, poor productivity, and relatively higher exposure to setbacks. Ultimately, public, and private, capital may be misallocated to less dynamic firms, with the unintended impact of reducing the economy's potential growth post crisis.

The scale and nature of interventions in this dire crisis have also implicitly placed government in a new role: the lender of last resort for businesses, but without an explicit policy for such a role. Against the risk of bankruptcy of some of the debtors, there will be pressure for debt to be forgiven, effectively nationalized, without any clear framework on how to make such decisions.

The government cannot afford this moral hazard. It has to make it abundantly clear that the aid is exceptional and one time, with clear terms and conditions, and a sunset. They are not matters for renegotiation. Taxes owed will need to be paid. EDC and BDC will make decisions on outstanding loans on the basis of commercial criteria. There will be bankruptcies. Again, policy must shift from short-term assistance to adjustment, and to building capacity for the medium to long term growth.

Government debt is cheap today—but what costs are we passing on to future generations

The federal government has been given exceptional political latitude to introduce and to implement the economic response to the COVID-19 crisis—including $228 billion of new discretionary spending in 2020-21 alone. With the roll-over of existing public debt, it will borrow this year an unprecedented amount of $713 billion, also with substantial latitude from financial markets given the global nature of the crisis and Canada's relatively low net debt-to-GDP ratio.

The economic, financial, policy and political context of the crisis has created an environment where such borrowings are possible. Global capital markets, already awash in cash prior to the crisis, are searching for safe investments. Central banks worldwide are injecting massive liquidity in the financial system. The Bank of Canada for the first time is going further and expanding its balance sheet through a regular program of acquisition of Government of Canada bonds – so-called quantitative easing. This is permitted by low inflation pressures, and indeed by a policy responsibility to insure against the risk of deflation. Added licence is coming from the fact that all advanced economies are pursuing more or less the same policies.

Because of record low interest rates, and despite a spike in the stock of public debt, the government in 2020-21 will incur debt service costs $5 billion lower than it did in 2019-20. An astounding result that is allowing the government to cast aside at this time any

discussion of tax increases or expenditure cuts to pay for its COVID-19 measures.

It is as if the added debt is free. Except that it is not, and therein lies the moral hazard.

Long term, the sustainability of the federal fiscal framework on its current track is founded on several fragile assumptions: that the economy returns slowly but surely on a solid growth path; that the emergency measures are wound up rapidly and fully; and, that interest rates remain historically low for a long period. Under such assumptions, nominal growth may exceed the interest rate on the debt, and the debt-to-GDP ratio can be stabilized at a new, but higher, level.

This may work, but reality has a painful habit of intruding. Our productivity and growth potential going into this crisis were modest at best, and will likely be weaker coming out of it. The political pressures to maintain elements of the emergency assistance will be intense. Demographic trends mean that a rising share of national income will have to be allocated to the health and welfare of seniors, with a moral obligation to do so made even more salient through this crisis. There will be other recessions, perhaps another pandemic. The Bank of Canada may feel constrained in its ability to raise rates if the impact on debt servicing would imperil a highly indebted economy.

Simply put, the continued accumulation of debt to support consumption today is effectively taxing the next generation and diminishing its capacity to deal with future challenges. This intergenerational inequity needs to be addressed now.

Governments today have to set out realistic fiscal plans for tomorrow, with a range of scenarios, and be clear with Canadians that there is no free lunch and that debt does matter. Canadians have remortgaged their house to get through this crisis and now must find the income to pay for it.

Getting Back to Basics – in the interests of all Canadians

This brings us back to where we were before this crisis, but with even greater urgency: the need to innovate, raise productivity, nurture and attract talent, improve our social and economic infrastructure, and improve our global competitiveness. The effective handling of the crisis today ought not deter us from the harder structural reforms that will be required to grow our economy sustainably and inclusively for the longer term as we also pay down the COVID-19 debt mortgage.

The questions before us are in large letters: how will we in fact sharpen our competitive edge? How will we expand and diversify our trade in a world shaped by China-U.S. strategic rivalry and a de-coupling of supply chains? How will we digitize our businesses, grow intangible capital, and earn the stream of income from our ideas? How will we tackle climate change while realizing the best value for our resources and meet energy needs responsibly? How will we deliver life-long learning, facilitate adjustment, and ensure wide participation in our prosperity? The greatest moral hazard for Canadians lies in evading these hard questions.

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