Retrospective Pandemic Insurance

A practical plan for rapid, near-immediate relief; protecting all affected UK businesses, organisations and individuals, at minimal administrative cost.

The government and people of the UK are making immense efforts to contain the Covid-19 pandemic. The virus will eventually be defeated. This though will not be the end of the crisis. Beyond the immediate public health emergency lies the challenge of rebuilding our economy post-pandemic, a challenge which could, if not dealt with adequately, turn a major but temporary crisis into a deep and long-lasting depression.

The task

The key economic problem is the threat of bankruptcy for UK businesses of all sizes from the lock down. Revenues of airlines, hotels, travel agencies and others in the tourism industry have collapsed. Bars, clubs, restaurants have been required to close. Millions involved in culture and recreational and other services have seen their incomes fall to zero. Within just a couple of months a large proportion of these businesses may have failed.

Once they have failed, it will be difficult for them to restart. Their assets are not worthless. New investors will eventually appear to buy their assets at knockdown prices. But re-establishing all the supporting business operations including their marketing, banking relationships and supply chains will take time. The same is true in reemploying skilled and experienced staff. For larger businesses the likely outcome is administration, reaching an agreement with creditors that allows some operational continuity and for the business to re-emerge relatively quickly on a reduced scale. For smaller businesses here is likely to be no alternative to liquidation, breaking up the business completely.

The absence of fully effective measures to protect business is the major gap in the economic policy responses taken by the UK government so far. Rishi Sunak and his team have worked hard and come up with generous support for employed individuals and self-employed on low to average incomes, but they have done little to protect those on higher incomes or prevent business failures. They have launched two major schemes of business lending; but bureaucratic rules limit the ability of smaller firms to access these schemes and, for those that can overcome these obstacles, all that is on offer is credit. Credit can delay but will not avert business failure from an extended collapse in revenues.

The task taken up in this paper is sketching out a simple approach to relief which can be used to provide immediate financial support to businesses, large and small, to non-profit organisations and to those self-employed who fall outside the safety net already provided for those on low to average income.

The relief formula

At the heart of this schema is a formula:

$$\text{required relief} = (\text{annual income loss } \% - 14.5\%) \times 70.8\% \times \text{income}_{2019}$$

These coefficients are illustrative, in practice they will be varied from sector to sector (these particular coefficients are taken from a supporting paper [Some Good News on Covid-19](#) calculated for a ‘representative firm’ using US data).[1] Once appropriate parameters are established, it is then a straightforward task for government, banks and others to calculate the amounts that will be due.

This formula has an ‘insurance’ rationale. The 14.5% is the insurance ‘excess’. No relief is forthcoming unless the annual income loss, 2020 compared to 2019, is greater than 14.5%. There is a 29.2% co-insurance. The relief only covers the remaining income loss, i.e. $100\% - 29.2\% = 70.8\%$. It is retrospective insurance because no premium has been paid upfront to purchase protection.

Applying this formula to businesses, the appropriate measure of income for the previous year (income_{2019}) is ‘value added’: i.e. the difference between the firm’s sales of goods and services and its purchases of inputs, other than wages and salaries and rent.[2] The reason for this is that firms will respond to declining revenues by reducing their purchase of inputs, so this does not need protection (but the same formula can also be applied to their suppliers, so relief passes down the supply chain).[3]

Applying this formula to self-employed individuals, with income above the 50,000 then the appropriate measure of income is gross revenue, with parameters set on a sectoral basis and some maximum level of relief.[4]

The rationale for this formula are as follows: (a) businesses should have enough money to continue employing all employees wishing to keep their jobs at 80% of their salary before the crisis (so this formula incorporates the already announced Sunak scheme for employees, one component of the 60.5% is 80% times the share of wages and salaries in value added);[5] (b) business should have enough money to continue paying all contractual rents on property; (c) business should have enough money to pay essential overheads such as security, basic running and maintenance costs for computer systems, insurance, and payment of interest and principal on debt.

Getting the money out quickly and fairly

A formula of this kind is necessarily only a rough and ready approximation to the true costs of business interruption. But a formula-based provision of relief has key overriding advantages, over the existing support to business based on UK government guaranteed loans or an upfront, slow and uncertain bureaucratic processes to give special relief.

- Recipients and banks can use the formula to calculate immediately on a month by month basis the amount of government relief that will be forthcoming. The payment of the relief should be made in the first instance to the bank nominated by the business or other organisation. The bank after taking repayment of the loan at a bank base rate plus a small margin for administration, then pass on remaining funds to the client.

[1] Based on the coefficients 14.5 and 25.0 in Table 1: 70.8=100-25÷(1-14.5). These coefficients should be tailored to the value added composition of each firm, using data on revenues, wages, salaries, and debt servicing from annual accounting statements, to ensure an appropriate amount of help: enough to save them from failure but avoiding being excessively generous.

[2] Realistically this will have to be applied on a national basis, to UK subsidiaries only. Ideally other countries will take a similar approach allowing global firms to be saved in the same way, but I am not too hopeful.

[3] Value added can also be thought of as the sum of wages and salaries, rent and profit. For non-profit the scheme only need protect wages and salaries, rent and any debt payments.

[4] A variation for small businesses trading as solely owned limited companies with no outside directors is also possible, setting a maximum pay out to avoid excessive generosity to those already well off.

[5] A correction may be appropriate to limit protection to firms with many high-income earners, with an alternative calculation based on number of employees and median national wage.

- It removes the politics from decisions about government support to businesses in difficulties: the largest and smallest firms are treated in exactly the same way. The system is fair because it is one approach applied to all.
- It is a dynamic arrangement with the amount of support increasing month by month the longer the lockdown and other pandemic-related income losses continue.
- There is minimal bureaucracy and this administrative processing is not required upfront but later, to prevent fraud or other gross misuse of the scheme. For example, any employer whose payroll falls substantially can be subject to clawback, to prevent them pocketing the money provided to maintain their employees on their books.
- The scheme can start within days (the time taken to work out the sector specific coefficients of the formula and rules for calculating on an individual firm basis). It can be in place to meet end-April costs for all qualifying businesses and organisations (though most will not pass through the excess until May). This is much more timely than the June pay out promised from the current support for the self-employed.

Objections

- Is this not simply too good to be true, a magic formula to save the economy that applies to every entity and individual whose income is affected by the economy? Well its not that good, but it is good enough and it is far, far better than letting many businesses, non-profits and individuals fall through the gaps in the safety nets established so far
- Is this not duplicating existing support? No, it is an add-on or top-up to ensure all who need help get some support.
- Is it not simply unaffordable? No, not at all. Obviously cost depends on the extent and duration of loss of revenue and income. If this amounts to 10% of GDP (perhaps an underestimate) then my calculations suggest this will cost less than 2% of GDP over and above existing measures.[6]
- Will it not save bad businesses as well as good.? No, the "insurance excess" means that businesses that are so unprofitable or highly leveraged that they go under with a month will not be saved.[7]
- Should we not leave the job of saving business to the banks and financial markets? i.e. address liquidity problems through loans not solvency. This a fair point, but it meets with the problem that only the largest publicly traded firms have adequate access to market finance. We need support now to all firms on a broadly fair and politically acceptable basis.[8]
- Is it not throwing good money after bad? The insurance excess stops payment to firms that already going under.[9]

[6] Things could get much worse, but even an additional 6% of GDP or more can be financed without borrowing. This can be done by imposing crisis levies on firms making large profits as part of the crisis response (see this related NYT opinion piece) and on a windfall tax secure wage earners such as University professors who continue to get a decent salary with no opportunity to spend it.

[7] The payout to firms should also be conditional on their still being solvent and trading after the crisis. Rapid draw down of funds followed by failure will be an indicator that fraud investigation is needed.

[8] IF politically necessary, there is no reason not to ask large firms with publically quoted stock to pay for the cash injection by giving the government shares at the pre-crisis market price. Private firms owned by private equity companies could also pay with stock based on sector

[9] Where a firm subsequently becomes insolvent during the crisis, despite the injection of bank money triggered by the grant, then ideally the government grant should become senior debt allowing some reclaim for the tax payer. I am uncertain though is this is legally possible.