Minimising the financial impact of the coronavirus lockdown

A rapid solution with minimal administrative barriers and low financial cost: fully guaranteed lending for all businesses and organisations followed by tailored pandemic grants

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The government and people of the UK are making immense efforts to contain the Covid-19 pandemic. The spread will be controlled and there will eventually be a return to 'normal' life, although a full return could be 12-18 months when we have a tested and widely available vaccine.

Beyond the immediate public health emergency lies the challenge of restarting and rebuilding our economy. This challenge could, if not dealt with adequately, turn a major but temporary economic shock into a deep and long-lasting depression.

To avoid long term economic impacts, a key economic objective is minimising the failure of businesses and other organisations must be minimised. This note describes a practical framework for achieving this goal, laying out a framework to avert the vast majority of threatened financial failures of businesses and other organisations and ensure they emerge without a major burden of debt holding back recovery.

The framework is to provide 100% government guaranteed loans (as has already been done by the Swiss federal government in response to the pandemic), based on loss of revenue, with guidance on how a proportion of these loans will then be turned into to grants for small businesses including sole proprietorships and non-profit organisations in order to cover their essential operation costs and so ensuring survival until the lockdown is over. This is framework supplements rather than replaced measures already taken to ensure minimal financial failure. The support is relatively low cost to the public purse (grants come to less than 2% of GDP for six months of support, much less than what is being spent on social security and for furloughed workers); and by avoiding administrative complexity, supports rapid dispersal of cash (within days) to address immediate cash flow needs.

Crucially it allows firms to survive as long as necessary while the overriding public health goals are met. It removes temptation to turn on the economic taps too quickly.

A key economic objective: minimising business and organisational failures

The coronavirus is causing many substantial economic problems. Most obvious is the loss of livelihood for millions, those thrown into unemployment and now relying on social security and charity for their basic needs. In the UK, as elsewhere, the government is recognising these urgent needs, announcing a major increases in social security budget for payment of Universal Credit (the principal UK social security system), doing what they can to accelerate decisions on social security payments, and also planning by end-April the launch of a furlough scheme through which will pay 80% of the wages for employees kept on employer books from February 28th instead of being severed from their jobs.

These are necessary measures to protect those most economically vulnerable. Job losses and furloughing are, though, a *consequence* of the lockdown. Following the reopening of the economy then, provided the businesses and organisations that employed them survive intact, a large proportion of those who have lost jobs or furloughed will be re-employed and we will return to something like previously levels of economic activity.

The principal barrier to our returning to something like previous levels of economic activity is financial failure. The threat of bankruptcy hangs over many UK businesses and organisations of all sizes. Revenues of airlines, hotels, travel agencies and others in the tourism industry have collapsed. Bars, clubs, restaurants have been required to close. Freelance providers of cultural, recreational and other services have seen their incomes fall to zero. Companies in businesses services, construction, and in agricultural and manufacturing supply chains, are threatened. This is not just a business problem: financial failure also looms for many non-profit organisations such as charities and cultural organisations. Failures of small businesses alone could well lead to a reduction of economic capacity – with associated loss of jobs and tax revenue – of around 5% of GDP and a total cumulative output loss *in addition to that resulting directly from the coronavirus lockdowns* of perhaps 15% of GDP (Milne, 2020). Failures of larger businesses could add further to economic losses. If failures of businesses large and small are allowed to happen unchecked, then we can expect only weak recovery next year, these figures suggesting 2021 GDP still 5% less than that of 2019 and a 2021 unemployment rate more than double the 4% of early 2020.

Chancellor 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. They have though done relatively little as yet to prevent business failure. They have launched two schemes of business lending (the Coronavirus Business Interruption Loan Scheme CBILS and the Coronavirus Large Business Interruption Loan Scheme CBLILS) ; but bureaucratic rules limit the ability of firms to access these schemes (the latter is not yet launched at all) and, crucially for those that can overcome these obstacles, all that is on offer is credit. Credit can delay but does not prevent an extended collapse in revenues leading to failure.

We need something better. This is needed not only to prevent permanent economic damage, but also because lack of protection against the financial impacts of the lockdown will result in substantial political pressure to quickly release the current restrictions and threaten in turn to undermine the public health achievements.

A proposed solution

The remainder of this note sketches out a simple approach to relief which can be used first 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 and then ensure they get enough grant relief to cover the essential costs of surving through the lock down no matter how long it lasts. This framework draws on elements of the economic responses in a number of countries, including Denmark, Sweden and the US, I have collected material on these and other countries in posts on my webpages https://alistairklmilne.com/ which also provides further discussion of the ideas outline here.

Lending based on loss of revenue that subsequently convert to grants.

The key points of this practical framework are as follows

<u>Guaranteed loans that involve no risk to banks and so can be paid out in days.</u>

- 100% government guaranteed loans of two-year maturity with no repayments for 12 months, that can in part then, subsequently, convert into grants. The lending is undertaken by commercial banks and non-bank lenders, but provided they have checked and based the loan on accurate revenue information (revenue in the last accounting year, loss of revenue compared to the previous year during the pandemic) then they are not liable to any losses. They earn a small administrative fee for managing the loans and loan repayments.
- These rapid loans are available to all businesses and non-profit organisations, including the self-employed, partnerships, and sole proprietor companies, where their cumulative revenue since March 1st, 2020 has fallen by 10% compared to the corresponding period of the previous year. New start-ups that do not have accounts for the past year are not eligible. If accounts for the past year are unaudited then the loan is based on revenues in the bank account not the unaudited accounting revenues.
- The role of banks in checking applications and dispersal of cash is thus extremely simply, as experienced in Switzerland the submission process can be set up in a coupe of days and then loans can be paid out in 2-3 days of receipt of applications.
  For those firms whose revenues have fallen by more than 10% compared to the same period as last year, then the amount loaned is based on the share of 'value added' in revenues as well as the loss of revenues over and above 10%. This is an effectgive way of targeting support where it is needed. Only firms with substantial revenue loss get guaranteed lending (others can apply through existing schemes). This formulation also ensures that financial support flows appropriately through the supply chain and that no business fails.

  The economics jargon "value added" makes this sounds somewhat complicated, but it is actually quite simple. A share of value added is what firms need to pay to keep alive (whereas they can always manage without purchase of inputs). First firms should be able to pay 80% of the wages of employees, whether retained in work or furloughed (up to the maximum wage that would be covered under the existing furlough scheme). Second they should be able to pay 100% of rent and debt servicing costs; third they should be able to borrow a share of lost profits (after debt service and rent but before taxes and depreciation, my judgement is that this share can be 25%) in order to cover fixed utility payments, rates and other business taxes, essential maintenance of property and equipment. Value added is simply the sum of these components: wages, rent, debt service, and finally profit net of rent and debt service.

  The resulting guaranteed loan is proportional to the revenue loss, and calculated using simple arithmetic calculations, for example for wages (assuming average wage bill in 2019 did not exceed the amount allowed under the furlough rules) would be
  $$\text{guaranteed loan} = (\text{annual income loss \%} - 10.0\%) \times 80\% \times \text{wages}_{2019}$$
  with a similarly simply calculation for rent, debt service (here the ratios are 100% instead of 80%) and for profits (here 25% instead of 80%).

- All UK firms regardless of size are eligible, except those in financial services.
- The loans are senior to all existing debt.

Subsequent conversion to grants to ensure all firms (those strong enough to withstand a 10% revenue loss) survive

- There is no grant to firms who do not remain solvent at the end of the two year loan i.e. the debt remains senior.
- Any grant conversion is computed after deduction of any other relief they may receive from other government schemes. So, they are not paid twice, both through this scheme and for the other existing schemes of rates relief, sectoral grants or the furlough scheme.
- The grant element requires subsequent 'loss adjustment' corresponding to those essential costs required to keep the business going. So if they retain employees in work that are essential to continued operation they can still get additional support, they do not have to furlough them to get government money. They get a grant for the interest paid on existing debt (in proportion ot revenue loss) but for repayment of debt principal. They evidence essential payments or these are estimated based on sectoral understanding of the loss adjustors.
- The grant element for SMEs (those with 250 employees or less) will cover all these costs in full. The grant element for larger firms will be limited, scale according to 250/ total employees. Additional money will be available but only in exchange for government acquiring a share of equity equivalent to half of the employment in excess of 250 (so if the firm has 5,000 employees they get 250/5000 of the computed essential costs plus they have an option for the other 4750/5000 of the computed essential costs for which they will have to give government a shareholding that ensures that shareholders contribute fully to the cost of support).

Why this is so inexpensive: less than 2% of GDP

The crucial point, explored in the Appendix to (Milne, 2020) and an accompanying spreadsheet, is that saving all SMEs including non-profits is *not* expensive compared to other measures being taken.

The following calculations assume that the downturn amounts to a complete loss of revenue for one third of SMEs (this is approximately the scale of the revenue loss, in practice the costs will be a little less than this because only firms with losses of revenue greater than 10% can claim the grants).

1. Rental payments of all SMEs in the UK amount to some 1.7% of GDP, or around £40bn per annum. If the scheme pays out on rental payments for one third of SMEs for six months it will cost £6.7bn.
2. Debt of all SMEs in the UK is some £191bn. Assuming an average interest rate of 10% then covering the interest component of one third of SMEs for six months will cost £3.2bn
3. Payment for essential non-furloughed employees are more difficult to assess. One measure is that the current furlough scheme is expected to cost the exchequer £24bn to furlough 3mn employees for six months. There are 2.7 million SMEs in the UK. If those with 5 or more employees retain ten per cent of their employees to do essential work, and this support is obtained by one third of SMEs, then the scheme will need to support 0.6mn. A similar amount of support may be needed for the micro SMEs employing 0-4 employees. So altogether this can be expected to cost £12bn (though note that if these firms fail many of even these essential employees will end up claiming social security, so the additional expenditure is smaller than this).
4. Other essential costs to maintain plant and equipment and operational systems are the most difficult of all to estimate. One possible metric is expenditure on depreciation, which amounts to around 200bn or 9.4% of GDP. If other essential expenditures amount to one

quarter of depreciation and this is covered for one third of SME for six months, then the total cost will be around £8.3bn.

Thus the total grant payments to save all UK SMEs from failure are of the order of £30bn or 1.4% of GDP. The amount of guaranteed lending will of course be larger, possibly twice as high, but the only additional cost will be where firms fail and the amount recovered as the senior creditor following insolvency is less than would have been paid out by way of grant.

The key point here is that covering the essential costs for six months of the one third of SMEs threatened by failure is not so expensive.

Even if the proportions of firms that can fail is higher (more than one third of SMEs) or the period of lost revenue is greater (more than six months for each of these firms) these costs are still affordable.

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