Treasury Select Committee - Call for Evidence on Covid-19 Financial Package

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The Government should be congratulated for putting together a bold package that helps provide for the under-privileged and vulnerable in our society, keep businesses afloat, and keep credit and liquidity flowing in the economy in coordination with the Bank of England. To face this unprecedented crisis, boldness is necessary.

In response to the Committee's call for evidence on the coronavirus financial package, we would like to highlight several areas where more support seems needed despite the exceptional and welcome measures already taken by the Government. We have presented these areas under ten distinct proposals that the Committee may wish to explore further.

Proposal 1: The duration of Jobseeker's Allowance should be extended by three months.

- Jobseeker's Allowance is paid for up to 182 days. The labour market will freeze given the current disruptions and more people will mechanically exhaust their unemployment benefits. Extending the duration of unemployment benefits through the expected period of drastically reduced economic activity (about three months) would have several advantages: (a) protect these vulnerable populations, (ii) reduce defaults on mortgages, and (c) preserve aggregate demand after the worst of the crisis is over. Benefit extension *would not create moral hazard from job seekers as the labour market is frozen.*
    - Extension of unemployment benefit insurance has already been implemented in several U.S. states

Proposal 2: The Government planned to pay 80% of wages for those not working during the crisis – this should be done only for firms that maintain their overall wage bill.

- The new scheme presented by the Chancellor is a very important and useful measure. However, the risk is that most firms will *lay off many workers now rather than using the scheme covering 80% of their wages*, as there is no real incentive to keep these workers. An alternative would be to allow firms to benefit from the scheme *only if they maintain their overall wage bills* (e.g., within 10% of wage bill over January-February).
    - Another possibility would be to 90% of wages for firms that maintain their overall wage bills, to give them an extra incentive to participate without amending this initial scheme already proposed

Proposal 3: The Government should cover 70% of rental costs and energy costs for small and medium-sized businesses, to reduce solvency risk and debt overhang for these firms.

- Economic activity is depressed drastically for many sectors. Because of the exceptional nature of this shock, which creates no moral hazard between firms, it is important for the Government to help firms cover their costs *even beyond salary costs*.
    - It is important to cover these costs directly to avoid debt overhang after the crisis. Interest-free loans are not enough because small firms have small profit margins and may become insolvent due to the temporary shock.
    - This proposal is justified by the exceptional nature of the crisis. <u>A complete discussion of the justification and implementation detail can be found in Appendix A</u>.
- We propose that the Government covers 70% of the losses incurred by small and medium-sized businesses due to rental payments and the cost of energy.
    - These costs are a pure loss because they are unavoidable and do not contribute to production later on.
    - The rate should be high but set below the coverage offered for workers (80%) because labour should take precedence.
    - No coverage is offered for other costs that can help promote production in the future (such as buying intermediate inputs due to binding purchase agreements).
    - This scheme could be extended to larger firms later, depending on how the situation evolves.
- The tax system (HMRC) can be used to implement this policy. Details are <u>provided in Appendix A.</u>

<u>Proposal 4</u>: Offer direct bonus payments to essential workers, including £1,000 to health care workers directly involved in the coronavirus crisis.

- The Government offer *direct payment of a bonus to health care workers*, for example £1,000 for health care workers directly involved in the coronavirus crisis, and £500 for health care workers not directly involved.
- In addition, the Government could *encourage employers to give a tax-free bonus* to all workers who are not able to work from home during the next two months, for example a £1,000 tax free bonus.
- Similar bonuses have been given in France and Singapore.

<u>Proposal 5</u>: Devote large additional resources to the health care sector

- The Government could immediately devote large additional resources to:
    - (i) staff the health care sector,
    - (ii) buy the equipment (like ventilators) that will soon be needed,
    - (iii) mobilize the resources to quickly expand hospital capacity,
    - (iv) direct all researchers and industry in the health field to quickly develop faster, cheaper tests as well potentially a vaccine.
- The Government's package could do more in this regard, especially in mobilizing innovation in the private sector, and identifying the industries that are crucial in the response. *Both financial incentives as well as exemption from some regulations would be adequate* in a time of emergency. One needs *war-type mobilization in the health sector* right now. This part of the package is currently lacking.

<u>Proposal 6</u>: Develop a temporary public employment program to help with temporary labour retraining and reallocation

- Due to the peculiar nature of this crisis there are great asymmetries in capacity utilization across sectors.
    - For example, alongside enormous slack in services sectors, such as restaurants and hospitality, there are immense shortages in the healthcare sector, production of medical equipment and home food delivery.
- The Government could establish a *temporary public employment programme to help with temporary labour retraining and reallocation*. The programme would address labour shortages, while retaining workers' attachment to their permanent places of employment.
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    - Employees would temporarily be on leave without pay, reducing employers' wage bill, but would allow workers to rapidly return to their original places of employment when the crisis subsides.
    - Similar active labour market policies were very successful during the Second World War.

<u>Proposal 7</u>: Consider establishing a moratorium of debt payments and mortgage payments

- A priority for the next few weeks is to stop default on loan payments by firms. The Government should consider whether it can coordinate the financial sector *in a moratorium of debt payments for a fixed time period*, or until the government deems it adequate.
- This could be complemented with a moratorium on mortgage payments. Mortgagors have entered this crisis with leverage nearing 2007 levels.

<u>Proposal 8</u>: Consider injecting equity directly into certain companies

- The Government must start planning and considering an injection of equity into some companies in some sectors of the economy. *Debt will not be enough, as already highly leveraged firms will have trouble taking on more debt.*
- What began as a health crisis could easily spiral into a financial crisis. The Government should devise a strategy to ensure that this equity injection will not lead to a wholesale nationalization of the economy or destroying its corporate governance.

<u>Proposal 9</u>: Prepare a package of policies for the after-shock.

- Preparing a package of policies for the after-shock is paramount. Once self-containment is past, the economy will have to produce in overtime to recover some of the lost ground.
- The government must consider large stimuli at this stage, *especially to the supply side of the economy*, which is more likely to be severely impaired. Conventional stimulus to aggregate demand through government spending and transfers may just produce inflation if the supply side is constrained as it seems it will be. Supply-side reforms, like *relaxing regulations and cutting taxes, including tax credits for investment and hiring*, would provide a way to unfreeze the UK's economy as quickly as possible.

- *Announcing this policy package now will reduce uncertainty* and get firms ready to invest once they can get back to business.

<u>Proposal 10</u>: Set up a task force to elaborate a contingency plan to support the economy in case the epidemic lasts for over 6 months.

- Most current discussions operate under the assumption of short-run disruptions of at most three months. Epidemiological research and the current situation in China suggest that the crisis could be much longer, and that disruptions to economic activity (e.g. through social distancing and establishment closures) *could continue for a year or more.*
- Due to budget constraints, it will not be possible for the Government to support all sectors and cover 80% of wages for everyone for a year. A task force should be set up right away to develop crises scenarios to identify the tradeoffs and key sectors, firms or households that should be supported in priority in case of a prolonged crisis. In this way the Government *would be prepared if the situation were to deteriorate further*.

We are at your disposal and would be happy to elaborate on these proposals or to contribute to HM Government's important efforts with any other inputs that may prove useful.

Sincerely,

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APPENDIX A – COVERING NON-WAGE COSTS FOR SMALL AND MEDIUM SIZED FIRMS

Diagnostic. The confinement shock depresses economic activity drastically for many sectors. Because of the nature of this shock, which creates no moral hazard between firms, it seems legitimate to consider government intervention to help firms cover their costs even beyond salaries. The goal is twofold:

(i) Liquidity: must make sure that firms do not go bankrupt because of liquidity problems during the confinement period. This is a standard "lender of last resort" issue, but with an unprecedented scale (see below).

(ii) Solvency & debt overhang: must avoid debt overhang for firms after the end of the confinement. In sectors where profit margins are small, debt-ridden firms may become insolvent after a long period of confinement. This pleads for providing a **transfer** to directly cover some of the costs ("pure losses") incurred by firms in the most vulnerable sectors. This could be called an **"insurer of last resort" policy.**

Challenges. These two goals raise two main challenges:

(i) Scale & timing: The liquidity issue is common to all major economic crises. But today the scale of the issue is different – most firms may need a credit line, and may need it quickly. This may pose operational challenges (standard credit facilities may be overwhelmed, as was the case in other countries like France).

(ii) Scope: The government may want to cover directly the losses of some firms beyond wages but the program should be structured to minimize cost to the government and avoid moral hazard from firms (which need to be incentivized to minimize the cost of the shutdown instead of letting the government incur the losses). It is useful to distinguish between two types of non-wage costs that firms will incur:

   a. Pure losses: costs that the firm can't stop paying and that are a pure loss, for example: (a) paying **rent** when the facilities are closed; (b) specific subsets of total cost of capital such as **interest payments**; (c) specific subsets of total cost of **energy** (e.g. to maintain the production area at the right temperature). The state could offer to cover most of these losses.

      i. Note: it is difficult to be precise about the nature of these costs, which are likely to vary across industries and across the firm size distribution. We propose to start with rents and energy costs.

   b. Committed costs where intertemporal substitution is possible: for example, (a) firms forced to buy intermediate inputs now because of **binding purchase agreements** but could use them later when production resumes; (b) **financial costs of debt** (interest + principal). For this category of costs, the state may only want to provide liquidities at a small or zero interest rate.

Proposals. Given these goals and challenges, the following could be proposed:

- 1. **Extending loans to firms directly via HMRC**
    - If there is an operational challenge in providing liquidity quickly to many firms, HMRC could leverage its existing relationship with all firms in the country.
        - This may not be necessary for liquidity purposes, as there is already a Coronavirus Business Interruption Loan program (to be launched this coming week); **it remains to be seen whether this program can manage the large number of firms that will probably apply**

        - A direct transfer form HMRC would make it possible to give a direct transfer to firm to cover their pure losses (cf proposal 2 below)
    - An alternative approach would be to allow firms to have **large overdrafts** with their current bank, with a **100% state guarantee** (guarantee in business interruption loan is 80%, which may be enough)
- 2. **Offering to cover most of "pure losses", with ex-post verification**
    - Firms can be told today that they can use the various credit schemes to get zero interest loans to cover their costs during the shutdown, including both "pure losses" and "committed costs"
        - The proposal is that a *large transfer* could be offered for pure losses, while committed costs could get a zero-interest rate with a potential haircut
    - It could be announced right away that **pure losses will be covered by the state ex post** at a rate of 70%
        - Because workers are the priority it seems sensible to remain below the 80% coverage rate the government offered for wages
        - Firm will have to report their "pure losses" to HMRC and will be allowed to not pay back the fraction of their direct loan from HMRC corresponding to this amount. As a starting point, rents and energy bills could be listed as the only eligible expenses.
    - With time ex-post, it will be possible for HMRC to **check** that the reported pure losses qualify as such. For example, use data on firms **bank accounts** to prove amount of recurring costs in prior months (this should be easy for rents and energy bills).
    - For "committed costs", it could be announced right away that the government may offer a "haircut" ex-post. The level of the haircut could be decided ex post depending on the strength of the recovery.
- Costing:
    - It is difficult to estimate precisely what the cost of covering pure losses would be for the govt, but the order of magnitude should be below 4% of GDP for a 2-month shutdown, which seems feasible at prevailing interest rates on govt debt
        - If seems too costly, proposal could be tailored to focus on industry with smallest profit margins, for which debt overhang is likely to be most important
- Comparing this proposal to existing schemes:
    - **The idea of covering firms' pure losses related to non-wage costs does not seem to have been considered so far**. The only scheme that gets close to it is grant funding of £25,000 for retail, hospitality and leisure businesses with property with a rateable value between £15,000 and £51,000. More should be done to avoid debt overhang when the crisis is over.