IfG ANALYSIS | CORONAVIRUS RESPONSE

INSTITUTE FOR GOVERNMENT

Bailout for business after coronavirus

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About this report

The coronavirus pandemic has led to the sharpest recession in living memory, and an unprecedented response from the Treasury in terms of economic support. In spite of the lavish generosity of Treasury's initial response, this report argues that there is a solid rational basis for the bailout package: urgent support to retain the UK economy's ability to grow in the next phase of this crisis. The government needs to keep its focus on growth, which means it will have to plan for a deeper and more tough-minded programme of support going forward.

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April 2020

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Massive crises such as that brought on by the coronavirus pandemic are not just like small crises, only bigger. Their very size distorts the field within which policy is made and evaluated, like a quantum experiment that bends space, time and gravity.

Nothing illustrates this more clearly than the rules around supporting business for this crisis.

Just six months ago, the Institute for Government published a report, *Bailout for Business in a No-Deal Brexit*, into how the UK might support business for the set of emergencies that would likely follow an abrupt exit from the European Union (EU) without a free-trade agreement. In retrospect, it is an archetype of the pre-coronavirus era, laying out the considerable constraints and trade-offs confronting any attempt to shield business from the costs of bad policy outcomes. Any economic intervention must be weighed against the risk of distorting business decisions, encouraging irresponsibility or impeding the unsentimental processes of 'creative destruction' by which an economy progresses.

In normal times, it is the job of any responsible Treasury to seek out as great a private sector contribution as possible. The expansive attempts to help the economy for the shock of the coronavirus pandemic, and instant shuttering of much of the economy, break almost every one of these rules.

In intention at least, the initial response from the Treasury is much less conditional, unlimited in fiscal scope, and deliberately aimed at shouldering a burden of the private sector – with far less concern for moral hazard or the need for market incentives to play out. As such, the moves have been rightly welcomed by commentators everywhere, and insofar as they are criticised it is for a lack of completeness or timeliness. Compared to the situation we attempted to assess for no-deal Brexit, it is an entirely different world.

This Analysis paper joins others in supporting this new approach, and even suggests ways in which it might be extended. But it argues, too, that this does not reflect a government that has abandoned all restraint but instead one that has conditioned its response to a highly specific, unusual and temporary set of circumstances. These circumstances are going to continue to change, and as they do the Treasury is going to have to adapt its response still more. A longer drawn out recession, which would turn a crisis of liquidity into a crisis of solvency, may demands more imaginative use of equity and grants – but also a tougher attitude towards the economic prospects of the businesses being helped.

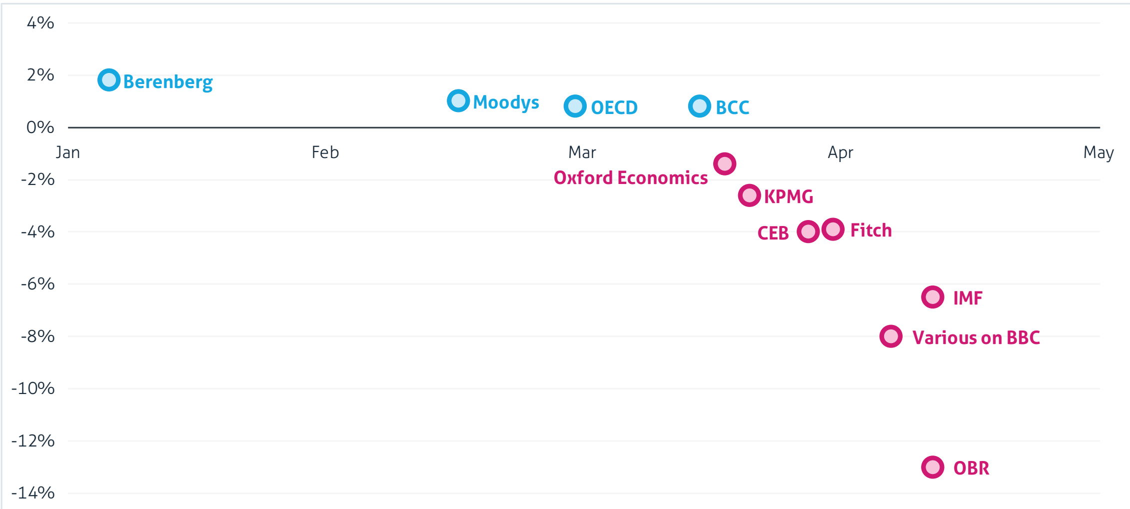
Preserving future growth is what matters above all, but the Treasury cannot allow "whatever it takes" to mean "no questions asked". Here, we suggest some of the key questions the government needs to pose if it is to support corporate Britain through its coronavirus crisis.

Setting the scene for the coronavirus bailout

The fundamental problem confronting any policy maker designing a bailout policy in the spring of 2020 is not just that 'we are in a new world'. It is that we are temporarily in a new world. The rules that work when the economy is deliberately shuttered are very different from those that will apply during the recovery and reconstruction phases. The challenge for the government is not just to think of ways that ensure the maximum possible generosity and speediest dispatch for the hibernation, but also to weigh up the medium-term impacts when conditions are different again.

What also makes this crisis unlike any other are the multiple layers of uncertainty that confront the policy maker. Covid-19 itself is still barely understood, the worldwide lockdowns to address its immediate spread are unprecedented, and at the time of writing the question of how economies will be reopened remains highly uncertain. Estimates for the economic damage caused are dependent on these uncertain lockdowns, and also the reaction of businesses and people never before confronted by this situation. Such estimates have therefore been shifting faster than forecasters can publish their forecasts.

Figure 1 **Declining forecasts for UK 2020 GDP**



Source: Institute for Government analysis.

This makes the task of designing any kind of business support extremely difficult, and puts a high premium on policy design that is robust in the face of a changing environment. That could mean either more generosity – should the economic outlook remain permanently depressed – or an equally difficult transition back to normality, should conditions allow. In such an environment, the goal cannot be to achieve a perfect outcome, but to minimise future regret. Mistakes will be made: the point is to avoid the worst ones.

The Covid-19 health crisis is very different from either the no-deal or global financial crises

From the advent of the Thatcher government in 1979 until the onset of the global financial crisis in 2007/08 UK governments steadily lost the appetite, and seemingly the pretext, for intervention in the economy. That crisis brought this era to an abrupt end, beginning with the rescue of the over-extended bank Northern Rock between September 2007 and February 2008. And in the autumn of 2019, Whitehall was gearing up for a new set of rescues in anticipation of the chaos predicted to follow a no-deal exit from the EU (see Boxes 1 and 2).

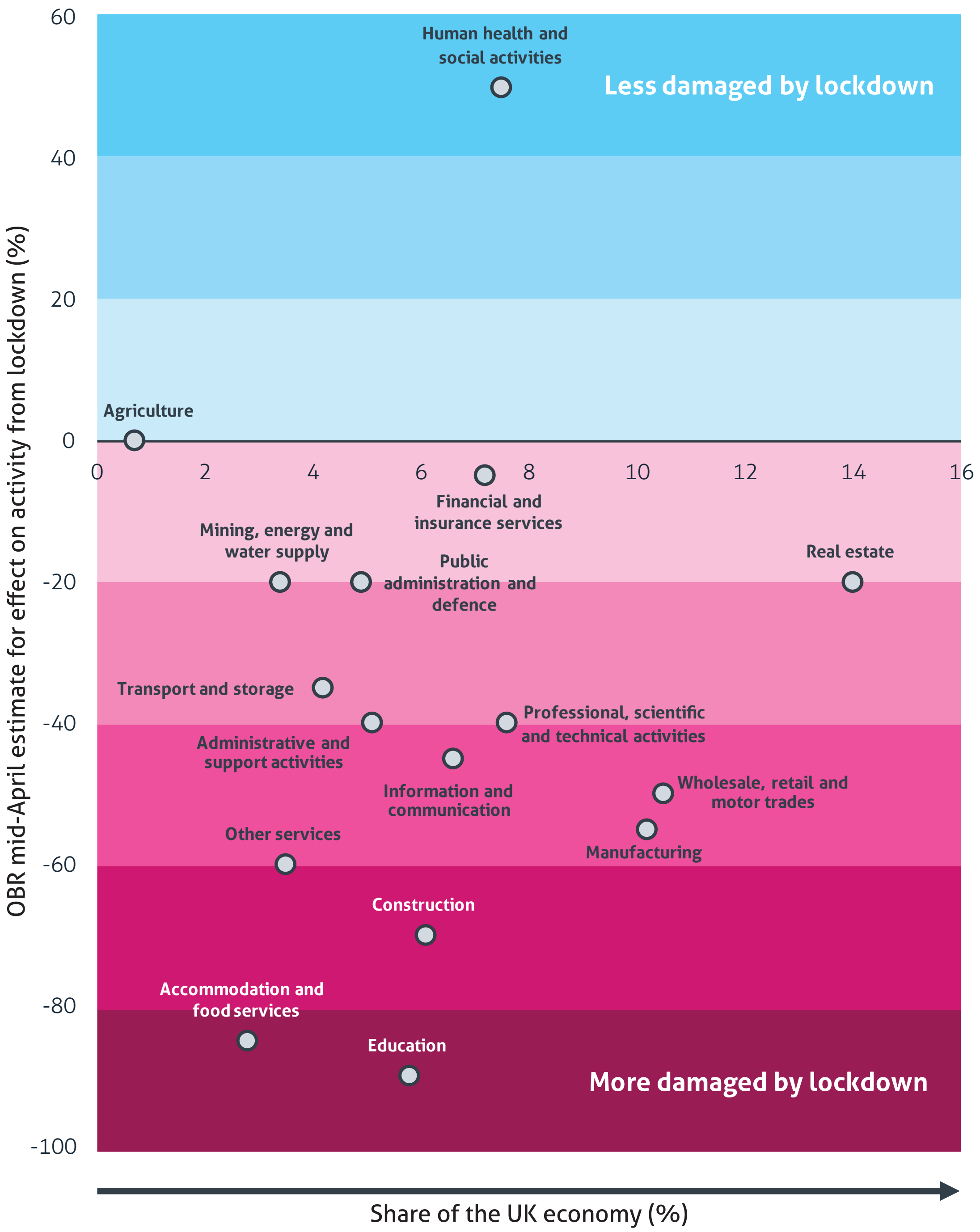
Coronavirus has heralded a wholly different economic emergency to either of these two situations. The greatest difference lies in how the pandemic has forced governments everywhere to fund the enormous costs, in terms of lost revenue, from this 'hibernation'. The coronavirus has imparted an immediate shock to the incomes of millions of businesses, and many millions of workers, much faster and deeper than seen even during the worst of the financial crisis. Normally in a recession, the effects spread across the economy as lower activity in one area resets expectations in another, prices fall and plans are changed. For much of the economy in March to April 2020, there has been no transmission mechanism at all, simply the immediate halt to activity.

The current crisis is different in other crucial regards as well. It is wholly exogenous to the economic system, like a natural disaster.[1] This can be contrasted with how the financial crisis was brought about by the banking sector, or a no-deal Brexit that would have been an emergency caused by the sudden change in the rules governing trade. The coronavirus crisis is global, but not globally transmitted in the same way that world recessions usually are, through trade and financial links; the pace of the loss of economic activity is wholly determined by the spread of the disease and government reactions to it.

The spread of the coronavirus has also been incredibly uneven in its direct economic effects. Some sectors of the economy have seen their revenues drop effectively to zero in a matter of weeks (something seen in no previous crisis), while others are relatively insulated according to whether they can continue under the restrictions imposed by social distancing: offices can allocate their workers with laptops for them to continue working from home in a way manufacturing plants or closed pubs and bars cannot.

Others see no direct impact but are likely to see strong secondary effects from the collapse in incomes of the most damaged sectors. For example, the utilities sector ought to see no immediate damage to supply or demand – people still need water, heating and light – but instead may experience a rapid rise in bad debts brought about by the financial distress of its customer base. And there are even some, such as home delivery, teleworking and other technological sectors, that may be seeing sharp increases in custom.

Figure 2 **Relative disruption by sector and share of UK economic activity**



Source: Institute for Government analysis of OBR assessment on 14 April 2020.

Box 1: No-deal Brexit as an exemplar of 'creative destruction'

Just six months ago, in October 2019, the Institute for Government published an analysis of how a government might approach another programme of business bailouts in response to a national economic emergency. *Bailout for Business in a No-deal Brexit* looked at the principles needed to guide state intervention in a failing business, and ran through some of the tools that would ordinarily be applied.[2] For a significant period last autumn, the prospects of a chaotic exit from the EU before the end of the year appeared to be a strong likelihood, and through processes like Project Kingfisher, Whitehall clearly took the prospect seriously.

From an optimistic standpoint, no deal would have heralded a short period of intense disruption, affecting particular sectors to an extreme degree and others not at all. The political impulse to pursue Brexit might have rendered some companies unprofitable and therefore in need of fundamental restructuring; others would have at worst seen a temporary loss of business through which they might have been tided over with a little extra finance or tax leniency. Our conclusions were that in such a scenario it would be right to address the likely cashflow issues through a period of forbearance in the tax system and a programme of guarantees via banks. Larger and longer adjustments to the more difficult trading environment augured by a no-deal Brexit might conceivably be funded with grants, but a permanent loss of competitive advantage is something no government can, or should, bail out a company for.

Ultimately, we saw no deal happening against a backdrop of a still functioning economy. The labour and capital markets were still expected to work, and on the whole must be left to do their job. This means that any attempt to 'bail out' a company for the effects of no deal should be heavily constrained by a free market reality check. If all the government is doing is temporarily cushioning a permanent loss of competitiveness for some company or sector, then it soon becomes as a case of 'throwing good money after bad'.

Implicitly, we assumed that most of the ordinary processes of a modern economy would have been able to continue, including the reallocation of resources and people from struggling sectors into others that are doing better – what is known as 'creative destruction' (a phrase most associated with the Austrian economist Joseph Schumpeter). This is a world in which the breakage and re-formation of economic links is judged to be on balance a good thing. Job market churn, corporate insolvency, investors making large losses in one area and profits in another – these are all free market means by which the economy shifts towards a better set of activities. Indeed, in light of the persistently weak productivity performance of UK business, particularly the small company sector, it might even be argued that the UK economy needed more such creative destruction.

Brexit itself is a programme of structural change, aimed at creating a new configuration of economic activity. Selling sheep meat to the EU is out, providing digital services to the booming Far East is in. This was a point in favour of allowing the free play of markets to reallocate economic resources as the market signals saw fit.

There are only echoes of this approach in the swiftly compiled programme of support generated by the chancellor Rishi Sunak's Treasury, such as through the holiday from business rates and VAT collection, and a large suite of bank loan guarantees. But in most other significant regards the differences between the imagined no-deal crisis and the actual emergency brought about by the coronavirus pandemic are significant. No deal was seen as very bad for the economy, but unlikely to risk a snowballing, macro-economic 'sudden stop' for the UK that Covid-19 now threatens globally, where markets no longer do such useful work.

As an exogenous event, there were early views that it would be transitory or 'V-shaped'

At the outset of the crisis, some commentators and politicians were confident that since the coronavirus pandemic was a knowable passing event its effect on the economy would be similarly transitory. Even by 16 March, a day global stock markets fell a near-record amount, Boris Johnson said that "if we can get the disease under control in the way that we're describing… there was absolutely no reason why economies worldwide should not come roaring back". John Springford and Christian Odendahl at the Centre for European Reform (CER) wrote around the same time:

> **The coronavirus pandemic is more predictable to epidemiologists, and therefore to governments… The infection rate will start to fall when most people who will get the virus will have already done so, and the economy will then start to recover. All this suggests that the economic consequences, while extremely severe in the short term, need not be as costly as the financial crisis.**[3]

A predictably short, 'V-shaped' recession (that is, steeply down then right back up) is perfectly suited for the provision of abundant, temporary bridging finance of the kind that the Treasury created so quickly from the run-up to the budget on 11 March 2020 and in the deteriorating weeks afterwards. As the CER wrote, so long as there is effective government action to support firm liquidity, lost wages and the health of the financial system, the economy ought to be capable of seeing through a temporary cessation of activity.

This optimism has become much less common since early March. Expectations for the global economy have mirrored the sharp fall in the stock market, and the latest forecast for the UK suggests that 2020 will contain the sharpest fall in GDP since the war (see Figure 1).

GDP is not the best measure of success for the immediate phase of economic support

The sheer oddity of 'economic hibernation' has caused some to question whether the traditional language of recession and GDP is appropriate. The government has actively ordered companies to stop production, so lower production can hardly be seen as a sign that its overall policy is failing. In the formulation of James Bullard, a US monetary policy maker, the enforced shutdowns and their associated costs should be seen as an "investment in U.S. public health".[4] But unlike ordinary investments, such as those made during a war when household savings are forcibly diverted from consumption to war-making products, Bullard's "investment" is one that leaves behind no kind of asset or production. It is fiscal spending to finance inactivity. This is another way of expressing how the normal urgent need to boost demand (i.e. spending) in the economy is temporarily misplaced.

Yet even if the hibernation aspect of the crisis is entirely novel, there can be little doubt that the broader economy is likely to suffer all of the normal features of a sharp recession. Unemployment numbers everywhere are already rocketing (and no doubt would be even higher in the UK were it not for furlough schemes), equity prices have tumbled by near-record amounts, and government debt levels are forecast to soar.

The current crisis might be expected to go through three broad phases

At the time of writing, there is no certainty around when governments might be expected to lessen the social distancing restrictions that have led to so much economic activity being automatically closed down or diverted. This report does seek to add to the work being produced that argues for any particular policy towards this, or the social and technological methods needed to make it possible.[5] But on the optimistic assumption that the social distancing measures work sufficiently for the economy to be allowed gradually to reopen fully, there are three broad phases that the crisis can be seen passing through, from an economic point of view.

- **Rescue**: the immediate response to UK-wide lockdown is all about shielding people and businesses from the immediate, unavoidable collapse in revenues. During this phase, which can be seen to have begun with the chancellor's package of coronavirus measures in his 11 March budget, the emphasis is entirely upon preventing destruction – of individuals' incomes, of people's jobs, of valuable business capital and organisational links that are key to the structural strength of the economy. The usual preoccupation of the economy departments with efficiency, market incentives and the protection of the public purse – the 'Treasury mindset' – is deliberately set aside.

- **Recovery**: as the economy is permitted to begin operating in a normal way, there will be an urgent need for activity to resume, spending to increase and incomes to recover. After a 'normal' natural disaster, such as a flood, this phase happens with little need for any extraordinary supportive policy; spending that 'went missing' was saved; such savings are then released again. Activity is merely postponed. But this paper argues that the recovery stage is by no means assured, as some early hopes implied; the sheer depth and disruption of the crisis during the rescue period means there is real potential for scarring effects that damage the ability of the economy to rebound straightforwardly.

- **Restructuring**: this paper does not seek to add to the already large pile of speculations about all the changes to the economy and society that coronavirus may leave in its wake. However, they are likely to be significant, both to how the economy works and to how public services are prioritised and funded. The economic damage will also contribute to a large fiscal reckoning, as the large debt and possibly significant deficit left by the crisis have to be addressed.

Each of these phases requires a very different emphasis in terms of 'policy virtues'. In normal times, a government might blandly claim it wants the best of everything: interventions that are good for the public purse, enhance market incentives, capture externalities, discourage reckless behaviour and pass the tests for fairness and redistribution set by the political climate of the time. Until the economy is well into its restructuring phase, however, we will be in far from normal times.

Table 1 **Importance of various policy virtues from Rescue to Restructure**

Policy virtues	Rescue	Recovery	Restructure
EFFECTIVENESS: getting money out quickly to as many companies as possible	VERY HIGH IMPORTANCE: at the pace of events the risk of private sector failure is extreme. Every day counts.	HIGH: depending on the scale of any problems with economic demand.	LOW: normal policy making prioritises good design over urgency.
DYNAMISM: respecting market incentives, supporting reallocation of resources, avoiding moral hazard, etc.	LOW: the market signals are badly distorted.	MEDIUM: the recovery phase is often when reallocation and insolvency happens.	HIGH: the countless ways coronavirus may have changed the economy requires nimbleness and clear incentives.
AFFORDABILITY: maximising private sector contribution, pushing for value for money, allocative efficiency within a tight budget	VERY LOW: the point of this stage is to use the state to help the private sector come what may.	LOW/MEDIUM: depending on the support the economy needs.	VERY HIGH: longer term, the scale of the fiscal challenge is already extreme.

This paper is largely focussed on the (first) Rescue phase of the crisis, because this is where the need for policy innovation is most pressing. However, awareness of the other phases to come remains important even during the hibernation. Policy making needs to be joined up over time where possible, and that can sometimes mean constraints or demands on current action in light of future imperatives. For example, this paper maintains that the overwhelming justification for a comprehensive approach in the Rescue phase is that greater support now can enable a stronger recovery in demand later – even if there is nothing that can be done about constrained demand in this initial phase. And it cannot produce packages of support large enough to keep firms alive for a few months, only to leave them so indebted that the Recovery stage is held back.

There has been consensus on the need for extraordinary economic support

Once the scale of the economic damage became clear there has been a remarkable consensus around the need for states everywhere to proffer immediate and almost unconditional support. This has even straddled political lines. Dozens of articles by academic economists and other policy makers have already proposed any number of ways of helping employees, the unemployed and small businesses. These range from guaranteed loans, income replacement for furloughed workers, greatly enhanced welfare payments, to lending that converts to grants if the business does not recover.[6] In the US there is even a proposal straightforwardly for the state to act as 'payer of last resort' where businesses itemise all their ordinary, unavoidable costs and just send the bill to the government. In Europe, the voices calling for central banks to print money and buy government debt, possibly permanently, have shifted from the fringes to the mainstream.[7]

These calls for support are different in a key regard from similar calls heard around the time of the financial crisis: whereas in 2008/09 the point was for the state to prop up collapsing levels of spending, the point now is for the state to take the financial burden of deliberately lower levels of activity.

Box 2: Even during the financial crisis there was never a 'whatever it takes' agenda to support every business

In the global financial crisis, states everywhere stepped in to act as insurer of last resort to the financial sector, through loans, loan guarantees and ultimately direct equity injections alongside outright ownership. There was also a massive demand stimulus through both fiscal and monetary measures. Yet even as this was being put together, and (in the view of most economists) staving off a collapse as threatening as the Great Depression of the 1930s, there was considerable political discord about whether it was fair. There were accusations that the bankers were being bailed out, despite having brought about the crisis, thereby encouraging more risk-seeking behaviour. The injection of money into the financial sector – with the purpose of supporting the whole economy – smelt of 'helping Wall Street, not Main Street'.

In the UK, direct support to employing sectors was relatively scanty. It was regarded as enough to stabilise the financial sector: once it could be assumed that the world of finance was able to make rational, unconstrained decisions, it was felt best to let it get on with it.

To take the retail sector as an example, barely two months after tens of billions of pounds were pumped into the shares of RBS and Lloyds-HBOS, the stalwart Woolworths was allowed to go bust, at a cost of 27,000 jobs.[8] The retail sector was one where ordinary capitalist mechanisms were still seen to be efficient; if Woolworths could not make a profit, the free market would find better uses for its staff and shop sites, and keeping it going would be unfair to other more efficient high street rivals. Over the next few years, similarly harsh logic was applied to other retailers Comet, HMV, BHS, Peacocks and others. The UK's constantly rising employment rate was seen as vindication of this approach – job losses and insolvencies as churn in an otherwise efficient and prosperous economy.

The state is trying to act as insurer of last resort to the whole economy

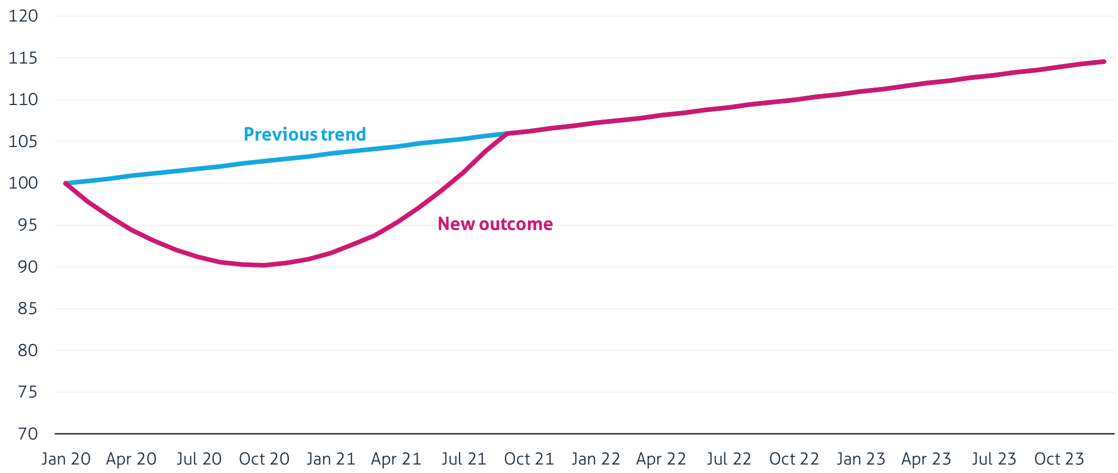
The high-level case for a maximalist approach to state support during the Rescue phase is quite simple to make. A natural disaster, for which no section of the economy can be held responsible, and none could have prepared for, that produces devastating effects unaffordable to many – to quote the economists Christian Gollier and Stephane Straub,[9] the cost of this must:

> **be shared fairly from an economic and financial point of view. It is as much a moral imperative as it is an economic one. Under the veil of ignorance, not knowing whether we are civil servants or restorers, we would all like to see this happen. Ex-post solidarity is ex-ante insurance. Only the state can set up such an insurance mechanism as a last resort.**

Whether or not a pandemic is considered a 'natural' disaster as such, it is hard to envisage a situation that better fulfils the conditions needed for the state to act as 'insurer of last resort' to the whole economy. In Bullard's terms, the aim for the state should now be to keep households and also the owners of capital whole. Neither is to blame for the current crisis, and to the degree that any one person, household, business or sector is disproportionately hurt, it makes sense that they are helped. The object is to preserve as closely as possible the pre-pandemic economy. As Gollier and Straub imply, it is fair to assume that had this kind of event been something we might have been able to buy insurance for, everyone would have bought it.

The Bullard investment that we all share can be simplified as a period of unavoidable and non-recoverable lost production.

Figure 3 **Representation of a transitory crisis**



Source: Institute for Government analysis.

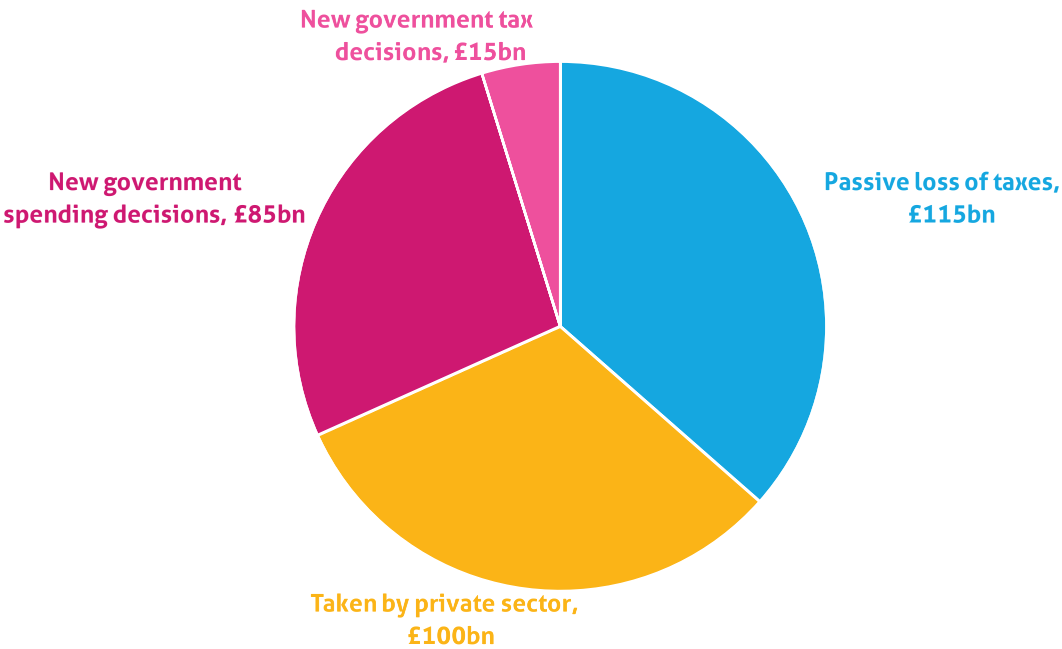
At a more granular level, this damage is highly uneven in its distribution, meaning that many sectors, businesses and people could not afford to finance the loss on their own.

But collectively the state is more than capable of affording it. In Figure 2, the cumulative lost production by the time the economy returns to path is about 13.5% of pre-crisis GDP – or about £310bn of GDP. In a very crude sense, that is the social bill for social distancing, and is very roughly what the Office for Budget Responsibility (OBR) suggested in its scenario in early April 2020.

Given the UK government can borrow for 20 years at less than 1%, and typical corporate and personal borrowing rates in the economy are 4–10%, it is clearly socially efficient for as much of the burden to be carried by the government as possible. To put figures around it, a £300bn debt repaid over 20 years with a 1% interest rate would require less than £18bn of annual payments; this would rise to £24bn at 5% interest.

On 14 April, the OBR published a forecast for the UK economy suggesting that the year 2020 would see GDP fall by 13%, and produced estimates for how this was impacting the government finances in terms of lost revenues and the cost of shielding interventions.

Figure 4 **GDP loss caused by coronavirus**



Source: Institute for government analysis of OBR assessment on 14 April 2020.

Essentially, with the UK economy as a whole foregoing £310bn of GDP, the state was passively accepting a loss of around £115bn from lower tax receipts, and had actively added to its borrowing by £100bn, with £85bn of that new spending ideas (such as the Coronavirus Job Retention Scheme) and the rest foregone taxes.[10]

Once this logic of state insurer has been accepted, as it seems initially to have been through the immediate, expanding and evolving determination of Sunak's Treasury, the challenge is not to devise the rationale for state intervention so much as the most effective means to get the money into the right hands. This is particularly important when the 'shield' packages that the government is putting in place also help to keep workers at home and businesses from operating, helping to contain the spread of the disease.[11]

In terms of political and economic messaging, the chancellor's vow to do "whatever it takes" has been successful. The most important aspect of this has been improved statutory sick pay, the Coronavirus Job Retention Scheme and the supplementary parts aimed at the self-employed, since these directly supported people in their enforced decision not to work.[12] Although a massive expansion on what is normal, these income-support schemes do not represent a total innovation so much as a necessary extension to the principles underlying welfare policy. It has long been accepted that the state has a duty to help out those thrown out of work in a volatile economy. The UK approach has generally been that welfare should incentivise an immediate return to work, but this principle has been abandoned for understandable reasons.

However, it is not normal to extend that principle to companies themselves. Business insolvency is usually seen as an ordinary and essential feature of a functioning economy, helping to maintain discipline, weed out inefficient firms and reallocate resources. The government's policy is never normally to ex-post insure every unlucky entity in the economy against misfortune it cannot have foreseen; this is neither practical nor philosophically coherent.

That the coronavirus pandemic is an unforeseeable disaster is not, on the surface, reason enough for this new approach. For most firms, most normal damaging events are highly exogenous and beyond their capacity to control, be that the behaviour of global markets, the success of a rival product or the gyrations of the economy. We saw in the financial crisis (see Box 2) an event beyond the control of most companies affected, and yet few governments made it their priority that no jobs should be lost or companies made insolvent – this would have been regarded as impossibly expensive, arbitrary or unfair, and ultimately pointless.

The task now for the Treasury is to understand what is different this time, and how long these differences will last, so it can judge the transition from the 'Covid-19 world' back to the more 'Schumpeterian' worldview that had hitherto shaped economic policy – if, indeed, such a return will ever be completely made.

"Whatever it takes" is not (just) about health or solidarity but preserving the economy for the Recovery phase

By accepting the idea that it has an urgent duty to prevent 'unnecessary' company failures, the UK government has crossed a Rubicon. This paper argues that this is more than just a political decision to express the government's solidarity with the suffering economy. Instead, there is a strong and justified rationale: that without sufficient 'shielding' of companies and people, the economy may prove incapable of rebounding with sufficient vigour when the health measures are finally lifted. The 'V-shaped' recovery that the Treasury is relying upon could be badly impeded by any kind of lasting overhang from the Rescue phase of the crisis. This might occur through a number of channels outlined here.

- **Sharply higher unemployment**: a steep drop in the number of people working can damage the economy through lower spending (by the unemployed) but also because it takes time to rebuild workforces, which may prolong the period during which the supply capacity of the economy is reduced. Over a longer timescale, unemployed workers can lose skills and only return to work in lower-productivity jobs. In a shorter time period, they may have firm-specific skills so that even if they do not lose marketable talents, an enforced shift to a new workplace will damage productivity. Evidence from the financial crisis found that workers who were permanently separated from an employer suffered losses in monthly earnings ranging from 2% to 12%.

From the same economists, there is a succinct statement of what policy should be aiming to avoid:

> Any policies that would be conducive to a major and persistent reallocation of employment following such a deep but temporary and unusual shock are likely to result in sudden destruction of firm-specific human capital and customer base, slowly accumulated over many years of investment, experimentation and selection, an unnecessarily prolonged stagnation in productivity, and an anaemic recovery.[13]

- **The knock-on loss of spending by the affected sectors**: consider a simple two-sector model of the economy where sector 1 has had its revenues wiped to zero by the crisis, and sector 2 is unaffected but has sector 1 as a customer. The 'health-induced' recession that begins in the first sector then transmits weaker spending into sector 2 and an economy-wide, 'ordinary' recession (i.e. one brought about by a loss of spending) ensues.[14]

- **Time required to rebuild companies**: the creation of an enterprise normally has a high fixed-cost element, a sunk investment that is lost if the company becomes insolvent and which takes time and risk-seeking capital to re-establish.

- **Balance sheets**: even for companies given access to generous financial terms, many will only survive the recession by taking on higher levels of debt. This may bias them in favour of deleveraging during any recovery phase, rather than investing and driving growth, thereby hurting the recovery. This situation is described as a 'balance sheet recession'.[15] Similar concerns motivate those worrying about "the lurking menace of a modern version of the 'paradox of thrift'", where everyone attempts to save at the same time, damaging the economy and lowering incomes.[16]

- **Damage to supply chains**: the experience of the US automobile industry in the wake of the financial crisis was that the sharp contraction led to fewer suppliers competing afterwards, competition being permanently damaged, and costs as a result being higher.

Bonardi *et al*, authors of a recent article about state bailouts, capture these effects well:[17]

> A wave of bankruptcies risks slowing down the post-crisis economic recovery. There is thus a negative externality (strain on aggregate recovery and growth) of entrepreneurial decisions (individual bankruptcies) – a textbook example of a situation that calls for corrective public policy. Moreover, it is important to preserve not only productive capacity but also aggregate demand for after the lockdown. Consumers and firms burdened by debt are less likely to spend during the recovery.

All of these varieties of damage are normally quite bearable for an economy in healthy condition. That the failing companies may stop investing, and their laid-off workers stop spending, is a matter for the macro-economic authorities, who can use their usual tools to keep overall spending at a high enough level that there are no serious knock-on effects.

But when a large section of the economy is suffering a synchronised stop, its ability to heal itself in time for the recovery may be under real threat. At such times, the destruction is nearly all plainly destructive, not creative, and the market signals that companies are being forced to adapt to are at best faulty.

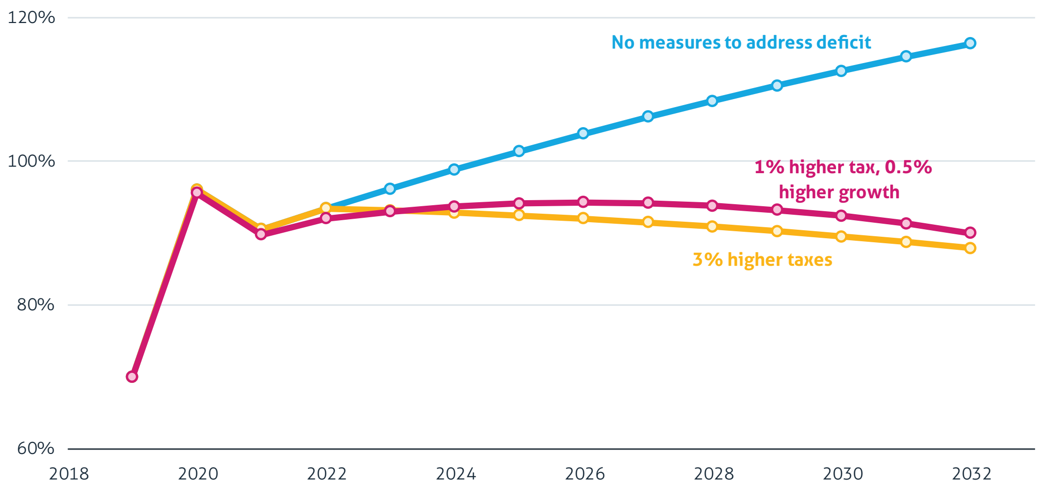
The question of affordability is secondary during the Rescue phase

In normal times, funds set aside to support business or industrial policy objectives have to compete against all other types of public spending, and cannot be increased without limit. This was one of the clear limits informing the conclusions we produced for our previous *Bailout*... report. On a crude calculation, the competitiveness hit caused to the services sector alone might have cost £30bn, annually, to compensate for – not something any government could sensibly contemplate.

But in the current circumstances, we think the trade-offs are different. First, the question is the degree of support provided right now, during the finite hibernation phase. In the case of business support, this is largely one-off spending that therefore impacts debt, not the deficit. With interest rates in nominal terms below 1%, the ongoing cost is very low. Second, the implicit assumption behind the Treasury's approach is that there is a real economic return to its fiscal spending right now in the form of a stronger economic rebound after the slump, and hopefully a stronger long-term pathway of growth further on. The more that the state helps out, the lower the levels of distress in the private sector afterwards, and the more capable it is of rebounding during the Recovery phase.

To illustrate this, Figure 5 presents a very simple model of the UK fiscal position after GDP and tax revenues are hit by a one-off shock and recovery, followed (as is likely) by a step change increase in spending.

Figure 5 **Simple modelled trajectories of an economy hit by a coronavirus shock**



Source: Institute for Government analysis. Basic assumptions of model: debt starts at 70% of GDP, cost of debt 2%, taxes 35% of GDP, non-interest spending 36% of GDP. Nominal GDP growth 3.2%, normal spending growth 3%; crisis causes 14% hit in year 2 to pre-growth trend followed by 10% rebound in year 3; spending rises 15% for one year followed by 12% fall the next year; taxes are raised in year 5 to address deficit.

Debt increases sharply in the year that GDP takes a dive and the deficit widens, which happens as a consequence lower tax revenues and a leap in spending. We then explore what quantum of tax rises will prove necessary to stabilise the path of debt/GDP. Crudely, a 0.5% improvement in the UK's growth capability in the years ahead enables this point to be reached with 2% of GDP less tax rises – a huge amount.

Even 0.1% of higher growth potential is well worth investing towards, if the Treasury can find support mechanisms to achieve that. Whereas an early increase in debt, while raising overall debt levels, does not significantly change the degree of measures needed to stabilise its trajectory.

Those suggesting that the UK 'cannot afford' this period of hibernation, or that it is not worth it in terms of the economic cost per life saved, are probably wrong.[18] But what the UK certainly cannot afford is for its economy to emerge from this crisis unable to grow strongly. The fiscal choices it faces then will morph from merely difficult to highly invidious.

Urgency, equity, calibration: principles for the coronavirus bailout

A key contention of this paper is that the government approach to Rescue-phase business support needs to be robust in light of the shifting phases of the coronavirus crisis. It must be flexible in the face of quite unprecedented uncertainty. Policy interventions invariably demand trade-offs, but the balancing point of those trade-offs will shift dramatically as circumstances develop.

The overwhelming imperative when lockdown first began was to prevent destruction of the assets, relationships and employment so that the economy is equipped for the recovery when it comes. The state should positively welcome claims on its balance sheet when the alternative is an indebted private sector unable to bear the risk and fuel a recovery. But when the economy is back on its feet, other virtues that protect dynamism and the free market economy will become more important.

The Rescue phase is a difficult time to be positively encouraging economic restructuring, given how chaotic the market signals might be when the economy is still forcibly shuttered. But the government cannot adopt a stance of helping any and every company damaged by the events of 2020, regardless of their long-term prospects. For example, there might be energy companies with projects premised on oil trading well above USD60 a barrel (at the time of writing, the figure is approximately USD20); it would be a waste of resources for the government to intervene on the basis that the pre-coronavirus oil market will return.

Likewise, it is fair when negotiating any mooted package for the airline industry for the government to be realistic about the lower level of flights that might occur in the future – both from people's reduced personal finances to voluntary changes in behaviour, for example by choosing to travel less.

When spending in the economy has returned, the job market is working again and the financial sector is functioning without support, the rationale for the government to protect businesses and people from the ravages of the market will be much reduced. Policies that improve the economy's potential in April 2020 might be actively damaging six months later.

The need to prioritise dynamism again[19] will become even more apparent if and when the recovery is secure and both business and government minds turn to restructuring both the economy and society in the wake of the pandemic. It is little use to complain that this is a job for future policy makers after the crisis is past – the financial markets have themselves already turned to this question.

The debate about the permanent alterations wrought by the coronavirus will rage for a while. This paper does not seek to come down on one side or another of this debate, but to observe that market forces aimed at restructuring activity will be in operation, and that there is questionable value to the state expending significant resources trying to stand in their way. Most of what the UK government has done so far is to make up for lost revenues that are funding adherence to its own medical advice – not countering chaotic or somehow 'wrong' market forces.

Most of the foregoing discussion, like the government, assumes a relatively short V-shaped crisis where recovery is in place by autumn. This is the scenario the OBR has also chosen to model in its first big attempt to grapple with the economic and fiscal impact of the pandemic.[20] However, to this point forecasts have changed very fast. Above all, the government should begin thinking about the possibility of a much more prolonged economic crisis, or simply a much longer hangover from the damage currently being wrought on the economy. The OBR itself acknowledges the risk of 'scarring' effects.

In short, policy has to be flexible enough to adjust, on one side, to the possibility of a rebound and recovery back towards a normal world of functioning financial markets, adequate demand management and beneficial, creative destruction – and an enduring depression on the other. It may appear like an impossible tightrope to walk, but there are general approaches that can help, which are the focus of the remainder of this paper.

Principles for the bailout

Deploy the familiar tools first

The Treasury and relevant agencies have a finite capacity to innovate and implement new schemes; in the initial phases the policy set needs to be broad and aimed at where the greatest number of companies and jobs can be reached quickly. The Treasury recognised this, and put to use existing, broad channels as far as possible – tax forgiveness, £12bn of easily administered grants to the smallest companies, and making use of existing banks and schemes currently in operation to direct loans.[21]

The first loan guarantee schemes to be offered were of this kind. The Coronavirus Business Interruption Loan Scheme (CBILS) is a straightforward extension of the Enterprise Finance Guarantee scheme (EFG) deployed during the financial crisis.[22] It provides a partial guarantee to a lender to smaller (sub-£45m turnover) businesses for sums lent of £5m and below. The Covid Corporate Financing Facility (CCFF) is even more straightforward, involving an offer by the Bank of England to buy eligible commercial paper (i.e. unsecured, short-term debt instruments) from larger, solvent companies suffering cashflow disruption.

Expect to constantly revisit the policies

The downside of falling back on familiar tools is that coverage is unlikely to be adequate at the beginning. The coronavirus crisis is so abrupt and unexpected that it has hit companies that would never normally expect to need support, and where the tools for delivering the support do not exist or are not appropriately calibrated. The government has already had to revisit and add to its interventions as new gaps have emerged, and should continue to do so.

In a similar way to how a scheme for the self-employed had to be added to the Coronavirus Job Retention Scheme (which was itself an innovation beyond the normal tools of statutory sick pay and unemployment benefit), the Treasury has needed to loosen the rules on CBILS with regard to the need for security and the role of personal guarantees, for example. A new scheme for companies above the CBILS threshold but too small for CCFF has also had to be created, the Coronavirus Large Business Interruption Loan Scheme, with slightly different terms.[23]

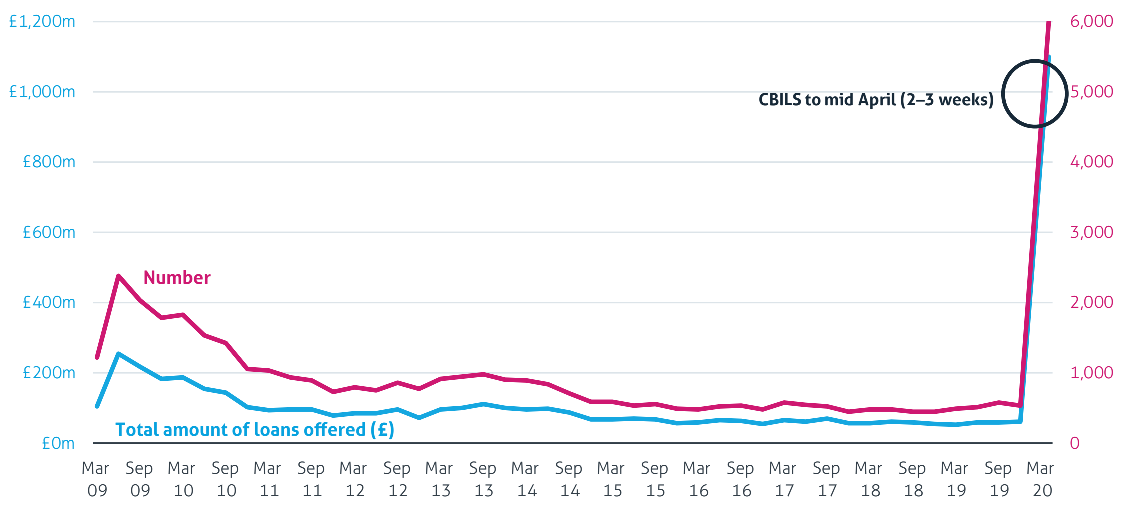
The former Chinese premier Deng Xiaoping said "cross the river by feeling the stones". Stumbling through a maze of unknown unknowns, this has to be the government's approach too. This was the case 10 years ago, in the wake of the financial crisis, where dozens of schemes for various gaps in business support were created, and even years after the worst of that crisis had past the government was still pursuing new innovations such as the Funding for Lending scheme.

Expect early administrative issues

There are millions of small and medium-sized enterprises (SMEs) in the UK, perhaps hundreds of thousands of them suddenly contemplating the need for a loan, many for the first time. Figures from UK Finance show that by the middle of April, 6,020 loans had been approved under CBILS, amounting to £1.1bn in total lending.[24] These figures came in for considerable criticism when weighed against the £330bn headline figure offered by the chancellor. There were immediate calls for the scheme's generosity to be improved.[25]

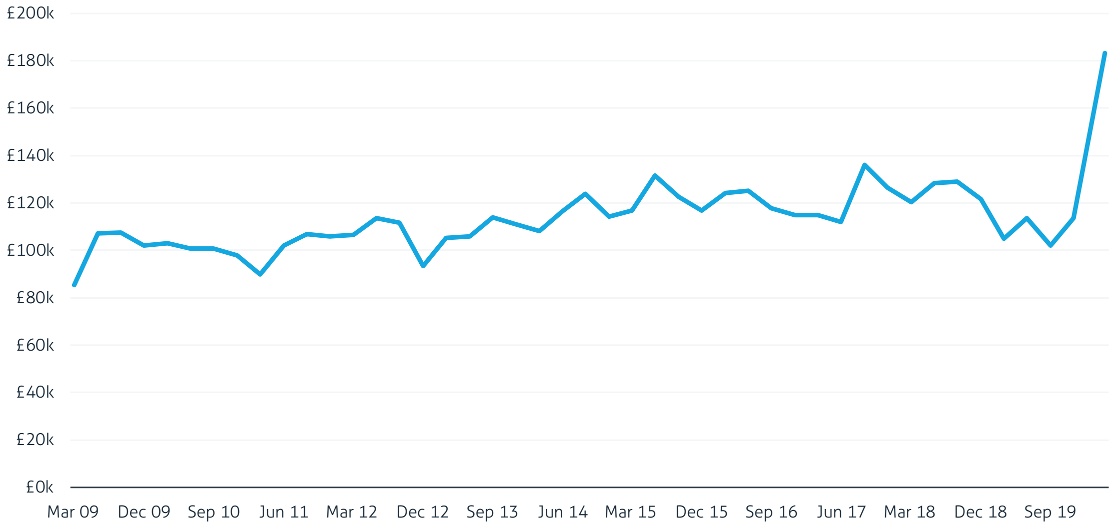
It is true that, compared to either £330bn or the outstanding stock of SME credit (around £160bn), £1.1bn does not appear to be much.[26] However, this is misleading context. Compared to the EFG scheme that CBILS is built on top of, the quantities and numbers extended look much more impressive. Not only have the numbers exploded, but the average size of loan has increased too.

Figure 6 **Coronavirus Business Interruption Loan Scheme vs the Enterprise Finance Guarantee**



Source: British Business Bank, Bank of England.

Figure 7 **Average size of CBILS loan**



Source: British Business Bank.

Moreover, if the EFG is the model, the whole outstanding stock of SME loans is not a good slide rule with which to evaluate the provision of loan guarantees like CBILS. In terms of sectors, ordinary and state-guaranteed loans hit very different segments, perhaps because the market failure problem that schemes like EFG are meant to address is more prevalent in certain kinds of business with less inadequate security or trading record. For example, figures from the British Business Bank show that 'real estate activities' account for just 1.6% of EFG lending, and agriculture 0.4% – while together these two account for 50% of all outstanding SME loans. Therefore the proper base against which to judge CBILS lending is £80bn of outstanding loans to business not including real estate and agriculture.

By good fortune, the EFG model has historically supported sectors to a greater degree that are now likely to be hit by coronavirus. For example, wholesale and retail trade make up almost a quarter of EFG lending, and just 9% of the loan stock, while for accommodation and food services the figures are 15% for EFG compared to 6.5% for the normal loan stock.

It should also be pointed out that the conditions under which the banks are operating are extremely difficult, in attempting to evaluate loans during a quite unprecedented period for the economy and also while adjusting themselves to lockdown conditions. A British Business Bank survey from 2019 found that barely a third of SMEs normally use external finance, and 70% would forego growth rather than take on new risk.[27] A rush of unfamiliar new lenders is not easy to service. There are of course examples of countries like Switzerland that have managed to deploy more loans more quickly – in part because of much easier lending conditions – but it would be a mistake to conclude at a very early stage that any scheme is not working. UK banks are now deploying many more staff to administer the CBILS scheme and so initial administrative difficulties may be transitory.[28]

During the Rescue phase, effectiveness and generosity trump efficiency

The government cannot hope to get everything right first time, and so has to choose from the beginning which error it is more comfortable making: too much or too little generosity. We would argue that given the risk of lasting damage from an unprecedented collapse in the economy, and the danger this poses to any recovery, the error to fear most is insufficient take-up. During the Rescue phase, the trade-offs are highly asymmetric. Insolvencies and job losses are not as easily mitigated as a spell of over-enthusiastic generosity in business support. In normal times, exuberant uptake of a government support scheme is evidence that it has been badly calibrated – see, for example, the fiasco around the Renewable Heat Incentive in Northern Ireland, or issues with the use of student loan schemes by new education providers.[29] The Rescue phase is not one of those times.

The logic supporting generosity is stronger when a generalised economic contraction is possible. Ordinarily, when a company is not supported and falls into bankruptcy, the gross amount of employment and activity lost is not a net loss to the economy; other companies may expand to fill the gap, other employers will hire the staff. During an economy-wide collapse, this is no longer the case, and the Treasury's internal assessment of the value of generosity should be adjusted accordingly.

The generosity that matters is towards the recipients of financial support – not existing or prospective investors

At the higher level, the government wishes to shoulder as much of the burden of lost incomes as it can, for which its major tools are benefit and furlough payments and foregone or postponed tax receipts. The simple logic of the state acting as ex-post insurer to the economy in a grand act of solidarity (see earlier section) is compelling and simple: no private sector entity is responsible for Covid-19, so let the state use its own balance sheet to 'keep whole' that private sector economy.

But, to revisit Bondari *et al*'s analysis, the point is not just solidarity but "to preserve not only productive capacity but also aggregate demand for after the lockdown".[30] At a time when the economy may be contracting at a pace of 10% in a month, the risks are of permanent, scarring damage to workers, their incomes and the organisations they might hope to work for. This might permanently impede the ability of the economy to rebound, like a spring that has been stretched too far.

This loss of 'bounce' is a real concern when the damaged entity is a worker or a corporation, but the case is less clear when it is investment capital. A company kept alive through the imposition of equity write-downs and a recapitalisation is fully able to participate in the recovery. Its assets and people are still able to operate, even if the original investors took a deep hit.

An important implication is that where the Treasury concludes that there is a working financial market capable of assessing conditions for a business in this crisis then it should allow that market to operate, rather than supplant it. If a company is able to attract finance without Treasury help, but at a higher cost than it might have with a government guarantee, then the difference between those two costs is simply a transfer of income from the state to the current owners of that company. That is not a good use of resources, and highly non-additional if judged in terms of jobs or personal incomes saved.

There is a reason that so much of the initial focus is on smaller companies – this is where the sheer transactional costs can prevent a good financial market from operating, and where the government-supported offer will often be the only one. For larger companies, conditions may re-establish themselves sufficiently well that there is private sector provision.[*]

There are good efficiency reasons to continue working with existing investors

New investment into a corporate situation is expensive and time-consuming at the best of times, involving long negotiations, due diligence, competition between different potential counterparties, and classic problems brought about by asymmetric information. Moreover, in a crisis there is the risk of a conflict of interest between existing lenders or investors in a company and any new ones, over priority and seniority.

To subsidise new investors coming into a company to fill a gap left by departing previous counterparties, at a heavy transactional cost, would be a poor use of state money. For example, a restaurant may be threatened by insolvency because a current lender is threatening to trigger a covenant in their current agreement, and receive 50% of its principal back through a hasty sale of the property. That restaurant might apply for a CBILS loan to pay off that lender in the hope for a new arrangement with a bank loan that is 80% guaranteed by the government. This would be time-consuming and uncertain of success, and possibly unfair – the current lender achieves a higher return as a reward for the threat to close the restaurant down. A better approach might be to allow the current lender to apply for a retrospective guarantee on its loan to the restaurant, in return for a commitment to extend the arrangement and hold back on exercising the covenant.

This instinct to preserve current relationships has been evident in other government interventions, such as requests for leniency from landlords to tenants and banks to mortgagees.[31]

The importance of working with existing investors becomes greater the more innovative the company or sector

Current support schemes are largely premised on the principle of lending towards companies that were profitable and sufficiently cash-generative that in pre-coronavirus times they would have easily qualified for a loan. This is a valuable principle; the point of the intervention is to keep afloat those companies that would have been viable had the coronavirus not struck, not bail out those that were failing anyway. However, this leaves a gap for companies that were expecting to run at a loss because they were early stage, still building the markets in which they plan to operate, or simply more speculative than the typical established business.

* For example, Ford Motor Company has raised debt at around 10% cost, and the world's biggest movie chain has issued USD500m of debt at 11%.

This is a fair description of the UK tech start-up community, who have launched the 'Save our Start-ups' campaign to request support tailored to the specific needs of early-stage companies,[32] and also the larger more established 'scale-ups'. The problems confronting this class of companies are not as easily evaluated as for long-established companies experiencing a sudden temporary fall in revenues (which are ideally suited to a state-backed loan). Start-up business plans usually include a long loss-making period during which time a market is built, and have hitherto relied on venture-capital (VC) backed finance. Now the companies will have seen future revenue forecasts thrown into disarray, and the VC ecosystem upon which they relied no longer as straightforwardly reliable.

There is no easy answer to this problem; many of these companies are inherently more speculative and likely to fail, which is why their backers expect a higher return when they succeed. History suggests new investors and opportunities will normally come in to fill any investment hiatus. Many VC and private-equity funds are raising new funds or sitting on unused investment capacity precisely in order to seek out the opportunities that the fallout from this crisis will throw up.[33] The government needs a strong rationale for any action that looks to either forestall or second-guess this activity.

However, for the long-term good of the economy the government ought to be concerned about a wholesale, synchronous collapse in the start-up economy, which has been a relative bright spot in the last few years. Since the businesses concerned are so idiosyncratic, a blanket scheme similar to CBILS is unlikely to work well. The risky situation of these start-ups and scale-ups requires an equity-investor-style insight into their prospects – not just a uniform assumption that March 2021 should be roughly like March 2020. The answer lies with an intervention further upstream into the equity ecosystem – pumping more risk-seeking capital into the equity investment funds that themselves are encouraged to continue supporting the start-up culture, in partnership with existing investors. On 20 April, Rishi Sunak unveiled a £500m co-investment fund along these lines.

Unlike with CBILS, CCFF and other loan-led ideas, this is not an intervention where the government should eschew any decent returns that reward the risk it is taking. That some other investors are critical of the state getting involved is perhaps a sign that the investment market for these companies is not entirely desolate, and the state's help is of less obvious additionality.[34]

Do not try to be too clever during the Rescue phase

There is a tendency among the commentariat and think tank world towards 'now more than ever-ism'. This argues for whatever agenda was judged to be important before the crisis being given the maximum possible push during the Rescue phase. Agendas that stood in January, but are now deemed more important than ever, include:

- bring about a more responsible corporate culture
- 'level up' economic activity around the country
- tackle decades-long inequality and social immobility
- take a global lead on climate change
- push the UK to the forefront of global scientific excellence.

While the government is throwing around billions of pounds, should it not ensure that these agendas are given a helping hand at the same time?

On the outside it is easy to make such calls, just a matter of adding a line to the op-ed. In practice, all extra conditionality has to be weighed up carefully against the risk of making the intervention too ponderous. The agendas listed above are longstanding and it is not exactly clear that the government has a straightforward toolset for addressing them, let alone during the chaos of an unprecedented crisis. At this time, it is far better if all the arms of government involved in business support have a single, overriding and clear goal: to ensure the economy is strong and ready for recovery.

Given the ramifications of failing to do that – including for any other agendas the government may want to pursue – a monomaniacal focus on restoring growth has never been more justified. There is going to be a long phase of restructuring and fiscal consolidation to follow the crisis: that is when other agendas can be approached.

Calibrate state commitment to the economic situation

In normal circumstances, a government intervention will stand or fall on whether enough private sector money can match the state's – this is a cardinal rule for innovation spending, for example.[35] As well as giving the government extra bang for its buck, the private sector contribution is intended to reveal important information about the worthiness of the investment: if no private money can be induced, then maybe there are problems with the commercial case.

During the worst of the coronavirus crisis, the informational content to be gleaned from the private sector contribution is very low; it may simply reveal what the investor thinks of the course of the disease, where its information is no better than anyone else's. As conditions normalise, the value of ordinary investor insights will be ever more valuable, as they learn to discriminate between better and worse prospects for the economic recovery.

Judging the shift between the market-sheltering and normal 'Schumpeter' phases of recovery will be extremely difficult and contentious. But the decisions will be less fraught if the nature of the support can be varied depending upon the government's assessment of the phase.

There are two rough kinds of generosity: the form of the support provided, and the conditions or costs within any one structure. For the form, Table 2 (overleaf) gives a rough idea of the various gradations of support from commercial loans and equity investment at one end, to outright, unconditional grants at the other.

In spite of the "whatever it takes" rhetoric, the government began its support of the economy with a set of interventions that sit somewhere in the middle in terms of possible generosity: it is more generous than simply letting the financial sector lead with the decisions, but markedly less generous than the sort of wholesale grant support that some economists have proposed.

Table 2 **Rough taxonomy of bailout mechanisms**

Increasing state contribution

Different methods	Illustration	Advantage	Disadvantage
Ensure a well-capitalised and supported financial sector, leave it to them	Government insists on banks not paying dividends, offers easier funding from Bank of England through the Term Funding Scheme for SMEs, lightens financial sector regulation and attempts moral suasion to encourage more lending. Also via the BBB the government invests in broad equity funds that themselves invest in start up companies.	**Small number of counterparties** – government can have all the people it needs in the room. **Preserves private incentives** – no moral hazard. Uses **existing** investor–company relationships. Less likely to **imperil competition or state aid constraints.** **Fiscally affordable** particularly if the government invests on commercial terms.	**Insufficient provision** – private incentives will not encompass broader economic advantage of increased lending/investment. **Moral suasion** – the 'governor's eyebrows' – is opaque and unaccountable. Asking banks to go against shareholder interests. **Does not reach those without current financial relationship**. A great many companies do not want external finance at all.
Direct loans from the state	UK government offers one-, two- and three-year funds to all qualifying companies with simple criteria, e.g. three-year record, positive cashflow.	**Avoids burdening the financial sector** – existing banks will have taken a hit from their current exposures. **Cheap for the borrower** – the state has the lowest borrowing cost which it can pass on. **The government gets (some of) its money back.**	**The borrower becomes more indebted and may be averse to increasing risk.** Many candidates will not want to take on more debt in any circumstances. **The state does not have a well-established, easily scaleable lending arm.** Perhaps the Bank of England buying commercial paper (CCFF) is the closest current mechanism, but that only works for larger companies. For smaller companies, it could prove slow. **Will certainly produce state losses** without experienced loan appraisal. The government may be left with only the credits turned down by the financial sector. This could also distort competition.
Loan guarantees	Like the EFG and CBILS. Government guarantee on 80% of new loan amount for qualifying borrowers.	**Removes catastrophic risk from financial sector** – the risk of a total default is no longer on the bank or other lenders books… **while keeping some private sector incentives** – banks or other lenders still wear the first 20% of losses, keeping in place encouragement to proper scrutiny. **Good value for money for the state if the recovery is strong** – the EFG evaluation of 2009 was good.	**Still requires considerable private sector scrutiny of e.g. security** and therefore slow. **Private sector lenders may still be too risk averse** – the upside of being involved is fairly low, even if the risk is capped. **Debt aversion still a major problem.** Borrowers are still on the hook for all the repayment, in a very difficult economy. **Banks unfamiliar with the process leading to teething problems, administrative slowness.**

Table 2 **continued**

Increasing state contribution	Different methods	Illustration	Advantage	Disadvantage
	Loan guarantees with equity element	Like EFG or CBILS, but with interest linked to future revenues or profitability, more like a preferred share.	**Better suited to the situation.** Loans that are only repaid if matters go well are flexible in the right way to the economic situation. **May be more attractive to private sector lenders** who have the prospect of a higher return if the loan is repaid. **Easier to price than equity.** No need to calculate the value of the company and its future profits.	**Complicated and often bespoke** – likely to be only deployed to large companies. **Still requires considerable private sector scrutiny** of, for example, security and therefore slow.
	Straightforward equity	The government via one of its arms (possibly the British Business Bank or new equity fund) invests money directly into the equity of companies in need of funds.	**Is well suited to the inherent uncertainty of the situation.** Not knowing the shape of the recovery, return is conditional on things going well. Avoids debt aversion. **For existing quoted companies easy to start doing.** **For sectors where government has interest, enables (some) control** so conditions around, for example, hiring can be maintained. Might help the **hard to reach** types such as loss-making startup companies.	**Many companies are averse to state ownership** which often comes with stigma and onerous conditions. **Many companies are very unfamiliar with equity** so only larger companies will benefit. **Complicated: establishing a fair price is very difficult – classic asymmetric information problem.** State either overpays and ends up with poor returns, or underpays and provides too little. **Requires new delivery body like a big state investment bank** and the **talent required is expensive,** which produces political issues.
	Grants repaid through tax	Companies accept a cash transfer in return for a temporarily higher tax on profits or conceivably revenues	**Has equity-style features** - so doesn't require repayment by loss making companies. **Might reach many more companies than actual equity stakes** – such as those companies that do not want an external financial relationship.	**Might be easily gamed** – profits are easy to manipulate, or managed insolvencies to escape obligations. **Grant-giving element** requires judgments and probably a new body.
	Grants	Government simply sends cheques to qualifying companies, or grants a tax holiday – for example, the £12bn grants programme already announced by the Government	**Most effectively addresses insolvency** including by reaching companies that want no external finance relationship. **Straightforwardly transfers a private-sector financial problem to the state.** **Less fiddly in execution than equity or loans** – no ongoing state–company relationship to manage.	**Expensive** – the state gets none of the money back directly. **High risk of inefficiency** – indiscriminate grants with few conditions risk giving money to those that do not need it (deadweight). **May discourage enterprise** if **conditions are linked to current distress;** the incentive to prosper is undermined. **High risk of unfairness** – in effect a transfer to recipients from non-recipients. **Grant-giving element requires judgments** and possibly a new body.

In terms of cost and conditions, the sorts of variables the government can look at altering include:

- the interest cost of the loans
- the term of the funding and the first repayment date
- the level of the guarantee
- any fees charged for the product
- the proportion of a furloughed employee's wages that are covered
- the size and quality of security required in a loan.

The case for 100% loan guarantees is weak

There are increasing calls for the state to insure the full amount of the small business loans originated by banks, including from former chancellor George Osborne.[36] Rishi Sunak met this call to an extent with the announcement on 27 April of 'bounce-back' loans of up to £50,000.[37] This is considerably below the average loan size issued so far, so the bulk of the government-backed lending remains with the 80% guarantee.

A very limited application of the 100% guarantee remains the right policy. A total guarantee removes all incentive on the part of the lender to exercise due diligence on the credit-worthiness of the borrower, or the prospects for the business.

Note too that the 100% guarantee is no more generous to the end borrower, who remains on the hook for the full loan amount, only to the bank. There can be little doubt that a 100% guarantee would increase loan provision, but logically it would do so by hastening approval for those credits that the banks would have been unsure of approving when the guarantee was just 80%. It would almost certainly mean money lent to companies that cannot repay on the expected schedule, or at all.

There may come a time when the government will have to contemplate sending out cheques with no certainty of repayment, as we discuss below. But insolvent companies need more unconditional money, either grants or equity, not loans. Unaffordable loans weigh on future company behaviour, rather than bolster them, and force companies to focus on paying down the debt rather than expanding. They also impose a heavier administrative burden on the government (or British Business Bank) who has to monitor the position. Put simply, if the government were to decide that it needs to engage in deliberately loss-making lending, it may be better value for money and simpler for it to just send payment of that likely loss as a grant to the company, than lend to it.

The small business sector that the loan guarantee scheme is aimed at is currently carrying around £80bn of bank debt (excluding real estate and agriculture). Under CBILS that debt is going to rise considerably – perhaps at the rate of £1bn a week, or more. At the same time, the ability of small companies to earn their way out of debt is surely going to be impaired.

There has to be a point at which raising indebtedness for this sector becomes counterproductive, through a combination of a heavier burden on the companies able to survive this crisis, and putting on life support those that the private sector would not want to go near. A 100% loan guarantee risks the scheme exploding far through the point at which state support for this sector is beneficial for the recovery. It would be far better to turn to outright equity or grants.

When flexibility is at such a premium and uncertainty so high, equity-style ideas become extremely valuable...

As discussed, a loan is not the ideal instrument for situations of high uncertainty. If circumstances turn out much worse than expected, companies struggle to repay and the loan may impede recovery, or even hasten insolvency. If the economy rebounds, the lender receives a disproportionately small return for the risk. Given time, situations like these would normally attract more equity-style financing, where the return is linked more to revenue or profit outcomes.

Ideas like these are already being discussed by economists and feature as part of other countries' interventions. For example, a group of European economists have called for a European Pandemic Equity Fund for large companies, and for smaller ones cash to be disbursed with repayment linked to future profits – an arrangement very like the state being given a silent equity holding in the company.[38] A similar idea in the personal-income space was proposed by the Harvard economist Greg Mankiw, for a kind of social insurance whereby citizens are sent a cheque with repayment linked proportionally to the rise or fall of their income in the next year.[39]

... and equity becomes all the more compelling as the economic skies darken

The government should prioritise its thinking about equity-style ideas from a purely precautionary point of view, and also the question of how loans might be replaced with grants.

The more that the economy deteriorates and a more U-shaped outcome becomes likely, the more that the government may have to contemplate a crisis of liquidity morphing into a crisis of solvency. Insolvent companies cannot usefully take on more borrowing – even if the lender was available, most company directors would be legally and morally constrained from doing so. If the GDP fall persists, a great quantity of the outstanding loans to corporate Britain may become impossible to service, and there will be no good choices available: either there are mass insolvencies and lay-offs, or loans need to be written down and replaced with other, 'softer' forms of finance, either shareholdings of some kind or simple grants.

Such ideas are entering the mainstream. For example, the new Bank of England governor Andrew Bailey (who assumed the role on 16 March, the day the prime minister was making known his optimism about the UK economy's bounce-back) mused to journalists recently about the notion of large companies receiving equity and small companies direct grants.[40]

New forms of support may eventually require new institutions

The government would have every excuse for saying its thinking is not developed enough for large-scale equity investment in corporate Britain. There is no template to work from. Normally, the kinds of intervention that are pursed through entities such as the British Business Bank, or funds like the British Growth Fund (BGF), are slow-moving and focused on growth rather than rescue. The BGF has taken eight years to deploy £2bn of equity capital into a couple of hundred companies, after being set up by UK banks in 2011. This is not a reflection of its efficiency so much as the intrinsic difficulty of finding good growth ideas in normal times.

If a difficult economic situation turns into a prolonged depression, the government will wish it started its thinking earlier about previously unthinkable ideas. Since the financial crisis, there have been repeated calls for the UK to have a state investment bank of some kind, often expressed in terms of envy of Germany and its KfW (a development bank formed in 1948, now with a balance sheet of half a trillion euros).[41] The British Business Bank was largely intended to operate within a typical Treasury framework of seeking out market failures and encouraging private sector finance to fill identified gaps – not to accumulate a massive balance sheet of direct exposures to the UK economy.

Coronavirus may be exposing a gap in the UK government's ability to invest quickly into corporate Britain, not necessarily mediated by banks or other financial institutions, but directly. This capacity takes a long while to develop, but it is quite possible that the crisis will be sufficiently drawn out that the government would regret not starting sooner in addressing it. The British Business Bank works well within its constraints, but those constraints apply best when the financial system is operating normally and ordinary rules around use of public money apply. It will take a new institution with a new remit to oversee the kind of direct investments and grants needed for a prolonged crisis. Articulating the answer to this is beyond the scope of this paper, but it would be a good idea for the Treasury to compile various options around a 'State Reconstruction Bank' or 'Coronavirus Equity Fund', capable of administering large-scale investments in UK companies, overseeing broad loan-for-equity swaps, and exploring ideas such as profit-contingent repayable grants.

The government should look at other ways of tilting the field towards equity

It is too early to say whether the landscape for corporate finance is going to be changed permanently by the current crisis, but the lesson of the financial crisis is that it well might. Banks were judged to have operated with much too low levels of equity capital (as well as too little reliable liquidity). Rule changes since have steadily ratcheted up these buffers – so much so that even in the face of a much sharper economic collapse the banking sector has remained relatively strong. Ten years after Lehman Brothers collapsed, the US banking sector was much stronger than the European equivalent. The best explanation is that it was much quicker to recapitalise, in particular through the US government's Troubled Asset Relief Programme.[42]

This time around, should the economy remain weak, the challenge will be to recapitalise much larger swathes of the economy. Hundreds of thousands of businesses will be insolvent and in no position to take on debt. It would prove vital in that situation to harness private sector capital, not just for the resource but for the insights needed to discern which companies can be saved and which cannot. A state investment bank could be a part of the picture, but it is difficult to envisage any single agency being able to reach such a large number of companies.

Another idea is to change radically the payoffs for investing in small companies, through changes to the tax system; for example, the 2010 Mirrlees review into taxation made a strong case for an Allowance for Corporate Equity, intended to level the playing field between equity and debt.[43] However, there already exist extremely generous tax breaks for investing in start-up companies such as the Enterprise Investment Scheme, and the evidence is not particularly strong that they have created a useful surge of equity investment. They are moreover extremely regressive – the mode of delivery is typically to let a higher-rate taxpayer off a capital gains tax bill. A proper, progressive means of boosting investment in UK corporate equity is still to be found. Doing so would be valuable, both short and long term.

Conclusion

The decisions the government faces in designing a robust bailout policy for corporate Britain in the wake of the crisis posed by the coronavirus pandemic are extremely difficult. This is the case even under the 'V-shaped' economic recovery scenario the government hopes for. In the initial Rescue phase, a total focus on delivery is justified – but as time passes and the economic outlook becomes clear, there may be extremely hard choices to make as we enter the Recovery and, eventually, Restructure phases.

The tools the Treasury has chosen to wield during the Rescue phase of this crisis are the right ones. They are quick to deploy and ideally suited to the hoped-for short and sharp recession. But the longer the crisis goes on, the more the government needs to contemplate an even more radical toolset – of forgivable loans, further direct grants and entirely new institutions – to support the recapitalisation of the UK economy.

The hope is that these tools are never required, but if the past few months have taught us anything it is that worst-case scenarios should be prepared for. The time to start doing so is now.

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