INSTITUTE FOR GOVERNMENT

Brexit and coronavirus

Economic impacts and policy response

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Summary

The UK economy has been hit hard by the coronavirus pandemic and any recovery has been delayed by a winter resurgence of the virus and renewed public health restrictions. More economic headwinds are on the horizon with the end of the Brexit transition period, at 11pm on 31 December 2020. Even though the UK and the European Union have managed to reach an agreement on a future trade deal, the UK's relationship with its main trading partner will change substantially.[1] This is likely to lead to disruption at the start of 2021 as well as longer-term economic effects.

Dealing with either of these shocks in isolation would be difficult for businesses. Dealing with both will be even harder. Businesses devoted time and resources in 2020 to finding ways to keep afloat despite the pandemic. This has left them with less time to focus on preparing for the end of the transition and financially weakened as they try to weather the short-term disruption – and adjust to the long-term consequences – of the UK leaving the EU.

Brexit and coronavirus are two shocks that are almost perfectly designed to substantially affect the entire UK economy. Brexit has and will continue to affect most of those sectors that rely on cross-border trade with the EU. Meanwhile, coronavirus has most affected non-tradeable services – those that rely on face-to-face contact. This means that few sectors escape unscathed: we estimate that 69% of the economy is badly affected by at least one of coronavirus and Brexit.

Rishi Sunak, the chancellor, has rolled out a raft of Covid measures – from wage subsidies to cheap business loans – to help businesses and households weather a severe but temporary shock. These policies will remain in place in 2021 and so could be used by businesses to help them cope with the effects of Brexit too when the transition period ends. However, these policies are not well-designed to help businesses adjust to Brexit. While coronavirus is predominantly a sharp but temporary shock to the economy, the UK's new trading relationship with the EU will not only create some short-term disruption, as the new systems are put into place, but will also permanently alter many businesses' costs and their international competitiveness.

To avoid wasting taxpayer money, we recommend that the government restrict access to coronavirus support schemes to only those businesses affected by that shock. To help businesses cope with the short-term Brexit disruption, the government should either design an alternative package of support or allow those businesses special access to the existing Covid-19 schemes on a case-by-case basis. Though trying to limit access to the schemes in this way will be politically very difficult, failing to do so risks poor value for taxpayer money and longer-term economic damage from delaying necessary economic restructuring.

There are four ways in which the government could target Covid support more narrowly: closing schemes early; restricting access to schemes to those who have already applied; imposing stricter eligibility requirements; and providing different support to different sectors. Schemes designed to support businesses through short-term Brexit disruption should include government-backed loans – ideally these would be on less generous terms than those provided for coronavirus, although it may be quicker and easier simply to extend those existing schemes – and further tax deferrals. More bespoke intervention – akin to that planned under 'Operation Kingfisher' in the event of no deal in 2019 – may also be appropriate.

In practice, the government may find it politically difficult to restrict access to coronavirus support schemes for businesses affected by Brexit as it would be perceived as unfair. However, the government should acknowledge that the political convenience of retaining broad availability comes at a cost. It will likely mean poor value for the public purse and could do further economic harm by delaying necessary 'churn' among businesses to allow more competitive sectors to grow and newly uncompetitive sectors to shrink.

How do Brexit and coronavirus affect different sectors of the economy?

The government's public health restrictions and changes in people's behaviour in the face of the coronavirus pandemic have led to a steep drop in economic output. The economy has begun to recover from the trough of April and May but output remains 10% below pre-pandemic levels and any recovery has been delayed by a winter resurgence of the virus. Figure 1, overleaf, shows how different sectors have been affected by coronavirus and how they are modelled to be affected by Brexit.

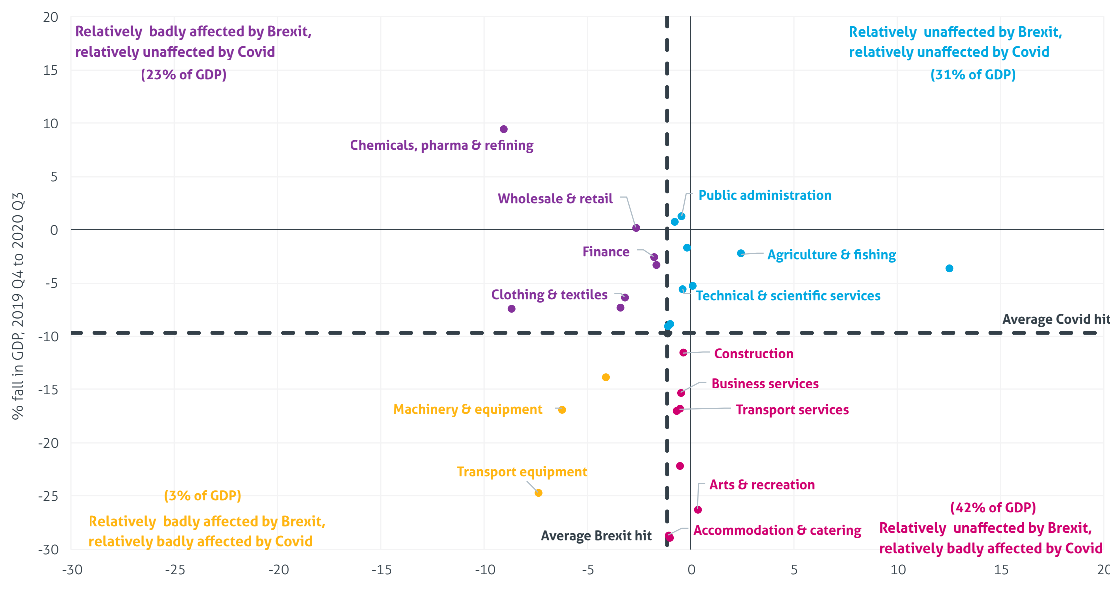
The effects of coronavirus on the economy can be seen in sectoral GDP data. The vertical axis of Figure 1 plots the change in GDP between 2019 Q4 and 2020 Q3 for different sectors.

Some of the impacts of Brexit have likely already emerged – although the UK's trading relationship with the EU has not yet changed, investors and businesses have started to anticipate the changes that are coming and to adapt their business plans accordingly. But the full impact of being outside the single market and customs union may take some time to materialise.

A variety of economic studies have attempted to estimate the impact of different versions of Brexit on the UK economy – in particular, how much larger or smaller each sector is likely to be post-Brexit than it would have been had the UK remained in the EU. The average of the results from two such exercises is shown on the horizontal axis in Figure 1 – these were carried out by two economic research institutions, one London-based (the Institute for Fiscal Studies) and one Munich-based (the ifo Institute for Economic Research).[2] In particular, this figure shows the medium-term impact of the UK and EU trading with each other under the terms of a free trade agreement, rather than the UK remaining a member of the bloc. This measure is highly uncertain and only includes some of the medium-term consequences (for example, it does not include the impact of lower foreign direct investment or dynamic effects which cause less open economies to grow less quickly, because it is difficult to allocate these costs across sectors).

However, these estimates are still likely to provide a good sense of which sectors will be relatively better or worse affected by Brexit in the medium term – although they understate the extent of short-term disruption that some sectors will experience, as we discuss below.

Figure 1 **The impact of coronavirus and FTA Brexit on GDP in different sectors**



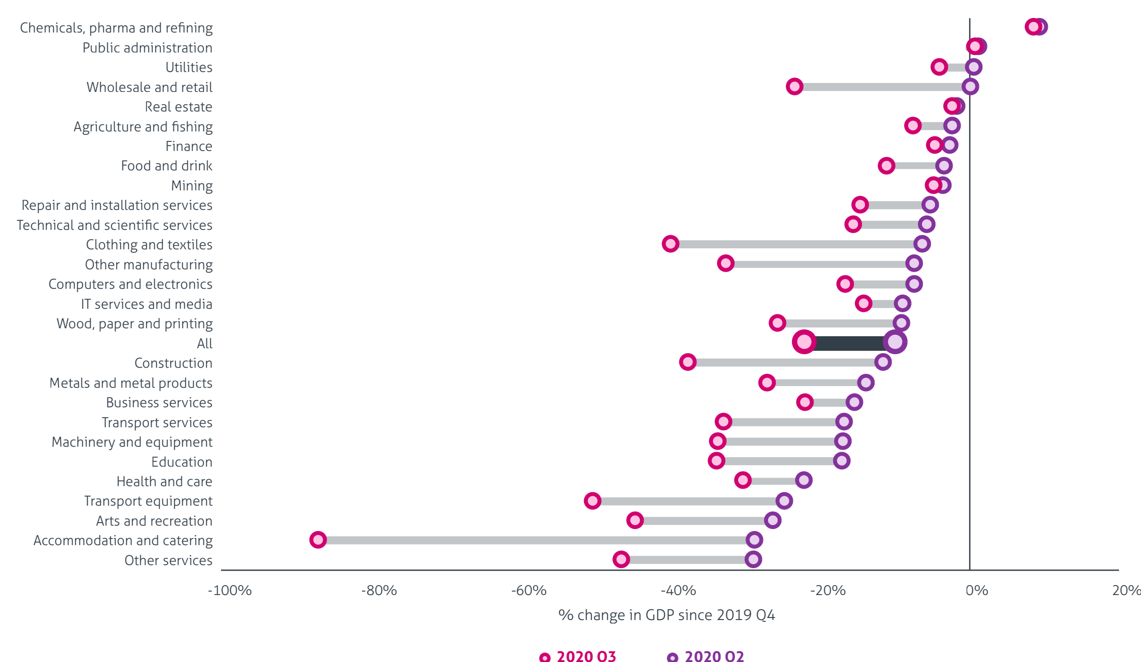
Source: Institute for Government analysis of Office for National Statistics, UK GDP low level aggregates, November 2020, Levell. P and Norris Keiller. A, 'The exposure of different workers to potential trade barriers between the UK and the EU', Institute for Fiscal Studies, October 2018 and Felbermayr, Groschl and Steininger, Brexit through the lens of new quantitative trade theory, ifo, March 2018.

Some sectors are badly affected by coronavirus and are also likely to be badly affected by Brexit (the bottom-left quadrant of Figure 1). However, on the whole, it seems likely that Brexit will hit hardest those sectors of the economy that got off most lightly from coronavirus, because Brexit affects sectors that rely on cross-border trade, which are less likely to be reliant on face-to-face contact. There are relatively few sectors that are expected to avoid major impacts from either Covid-19 or Brexit (the top right quadrant). Most of the economy will be hit by one or the other (or both). In fact, the nature of the two crises means that between them the shocks cover almost as broad a swathe of the economy as possible: with Brexit affecting tradeable sectors such as pharmaceuticals, while Covid-19 has hit non-tradeable services sectors like arts and recreation hardest. Sectors badly affected by both Covid-19 and Brexit represent only 3% of GDP. But few sectors escape unscathed – 69% of the economy is made up of sectors that are badly affected by coronavirus, Brexit, or both.

Face-to-face services have been worst affected by the coronavirus crisis

Coronavirus led to a sharp economic contraction in 2020. UK economic output in the third quarter of 2020 was 10% smaller than it was in the final quarter of 2019. Some sectors have been hit particularly hard. The first lockdown in April and May led to a sharp fall in output in many sectors. Hospitality and retail were closed but there were also large drops in output in industries where work cannot be done from home, because employers and workers felt bound by the "stay at home" instruction.[3] As Figure 2 shows, there was therefore a sharp fall in output in the construction and manufacturing sectors (such as clothing and transport equipment) in the second quarter of this year, alongside the pronounced drop in output for accommodation, catering, wholesale and retail businesses.

Figure 2 **Change in GDP since 2019 Q4 across different sectors**



Source: Institute for Government analysis of Office for National Statistics, UK GDP low level aggregates, November 2020.

But since then – and including during the wider lockdowns imposed in England, Scotland and Wales during the autumn – people have been able to go to work if they are unable to work from home; many businesses have also been able to adapt their workplaces and work practices to enable socially distanced working. As a result, output bounced back in the construction and manufacturing sectors in the third quarter, although remained 25% below pre-pandemic levels among car manufacturers and other businesses producing transport equipment. Activity is likely to have been able to continue in those sectors in the fourth quarter.

It is not surprising that the main impact of health restrictions in recent months has been on food and accommodation services, and arts and entertainment businesses, which rely on face-to-face contact. Social distancing prevents them operating normally and public health measures have periodically forced some businesses to close during the autumn and winter. Activity did rebound strongly in these sectors in the third quarter, despite ongoing public health restrictions. However, their output remained 29% and 26% (respectively) below pre-pandemic levels and will have fallen back in the fourth quarter as more stringent lockdown measures were imposed across the UK. Other badly affected sectors include aviation (because people are flying less) and administrative and support services (which include travel agents and businesses that provide staff for office buildings, many of which are closed because people are working from home).

Most other sectors, where people are either able to work from home or work normally while socially distanced, have been much less badly affected by coronavirus. Any impact on their output is likely to be through secondary channels, such as reduced demand due to falling incomes or reduced consumer spending in the face of economic and public health uncertainties.

It is difficult to know which sectors will be permanently affected by coronavirus

It is very hard to know which sectors will be adversely affected by the pandemic in the longer term, once the virus ceases to be a major public health threat and restrictions can be lifted. At the moment, most economists expect coronavirus to cause a permanent irrecoverable loss in economic output. That is, even after the pandemic has passed, the economy will be smaller than it would have been had the pandemic never hit.[4] The main channel through which the short-term impacts are likely to have long-term effects is 'scarring' – workers becoming less productive due to a loss of skills and a loss of attachment to the labour market; viable businesses going bust (or not being started); or businesses investing less than they otherwise would have done because the pandemic reduced their cash reserves or left them heavily indebted. Scarring is likely to have a broad effect across the economy.

Further to this, some specific sectors or areas of the country could experience additional long-term effects of the pandemic. Consumer behaviour and preferences could be permanently altered. The patterns of behaviour that seem most likely to change are patterns of working – in particular we could see more working from home and less business travel. If this were to happen, it would be bad for the aviation sector and administrative and support services. It would also likely reduce demand for city centre shops and cafes.

In all three instances, however, lower GDP for these sectors or areas would not necessarily be bad news for the UK as a whole, as the shift in behaviour could lead to other benefits – for example conducting more interactions virtually, rather than in person, could boost productivity in some sectors, and demand may increase for cafes and shops closer to people's homes to replace demand for city centre vendors.

Short-term Brexit disruption will affect many sectors

The end of the Brexit transition period will affect the economy in both the short and long term, with effects again concentrated in some sectors more than others. The impact of Brexit in the short term is very uncertain. There has been extensive modelling of likely medium-term impacts (discussed below and shown in Figure 1), but this sort of modelling is not possible in the short term, where many of the factors at play are extremely unpredictable.

However, some disruption is almost certain. Delays are likely at the border as traders adapt to new customs and regulatory requirements and new IT systems bed in, not helped by poor trader readiness and late delivery of key border IT systems. In the government's reasonable worst-case scenario, lorry queues could be as long as two days.[5]

There is also a risk of widespread non-compliance with new regulatory requirements. Businesses in the UK and EU will face new rules in areas ranging from product standards to what activities are permitted on short-term business visits, and could find themselves accidentally acting unlawfully if they are unaware of the changes or have not had the time or bandwidth to prepare.[6]

Leaving it so late to reach an agreement on the future trading relationship, with negotiations not concluding until just a week before the transition period ends, has made it especially difficult for businesses to prepare and the government has not been effective at communicating what they actually need to do.

In general, the sectors and businesses most at risk of border disruption are those that import from and export to the EU extensively. These include many manufacturing businesses, as well as agriculture. If disruption at the border leads to long queues and delays, all goods importers and exporters will be affected. Some businesses will have been able to mitigate this disruption by, for example, stockpiling inputs to their production processes or scheduling regular plant shutdowns to coincide with the end of the transition period. Large supermarket chains, as well as more than half of firms in motoring manufacturing, have stockpiled or plan to stockpile.[7,8] However, businesses that are unprepared for Brexit (for example, if they are not aware of additional forms or checks required especially on the EU side or have failed to hire the customs agents they will rely on to complete those checks) are vulnerable to disruption.

Regulatory changes will also affect the services sector, including legal, professional and business services. Leaving the single market will lead to new restrictions on how firms provide services, and in some cases may mean they are unable to continue providing services as they do now.[9] UK professional qualifications may not be recognised in the EU at the end of the transition period, with firms likely to have to navigate complex rules that may vary between member states and professions. For businesses not prepared for these changes, disruption will be immediate, although it is possible that some may continue to offer services unaware of the illegality of doing so.

Recent Institute for Government research on the UK's readiness for the end of the transition period highlights that sectors which are heavily affected by changes to regulation are better prepared because they have been aware of requirements for some time.[10] This includes financial services and chemicals and pharmaceuticals producers. However, that research also highlighted that small businesses across all sectors are much less likely to be prepared – a point that was confirmed by a survey conducted in late November by the Office for National Statistics.[11] This is a concern not only for those businesses but also for large businesses that rely on smaller suppliers. For example, major car manufacturers can have up to 400 direct and many more indirect suppliers further down the supply chain. Firms at the top of these supply chains do not always have good visibility of Brexit preparations beyond their tier 1 or 2 suppliers.

The extent of short-term disruption will depend on several factors. These include how ready businesses are for checks, how effective the government is at preventing unprepared traders from reaching the border, and any additional mitigations the EU and UK government might put in place to soften checks. However, some disruption is almost inevitable. Businesses are likely to experience reduced cash flow and activity as trade is delayed. Those in breach of new rules, such as the requirement to prove compliance with EU regulations, may even be out of action entirely in the short term, while changes to terms of trade may mean that some businesses need to overhaul supply chains in order to remain profitable.

Sectors reliant on EU trade will be permanently affected by Brexit

The longer-term effects of Brexit for many businesses may be larger than the short-term disruption they face; those effects are – in some ways at least – more predictable and have different implications for government policy than the immediate disruption. This is true even though the UK has signed a free trade agreement with the EU, because the UK will be outside the single market and customs union.

Most of the effects of Brexit are likely to emerge over the medium term as the UK economy adjusts to its new, less favourable trading position with the EU, which will make UK producers less competitive. These changes are expected to more than outweigh any positive impact of new trade deals that the UK might strike with other trading partners.

The main impacts arising from Brexit are likely to come from new barriers to trade between the UK and the EU, which is the UK's largest trading partner.[12] While some of these may be one-off impacts – such as the need to invest in new systems or to comply with a new regulatory regime (the chemicals industry estimates this will cost £1bn) - many will be ongoing. The deal the UK and EU have struck means that no tariffs will be applied to trade between the two sides, but non-tariff barriers – which have a bigger effect on trade on average – will increase (even though they will generally be lower than they would have been in a no-deal scenario). Examples of these non-tariff barriers include additional checks at the border and the need to comply with UK and EU regulatory regimes in areas like product standards, chemicals regulations and financial services. Further impacts may also arise from a fall in foreign investment and changes to the migration system which will make it harder or more expensive for some industries to hire the workers they need.

The benefit of a deal, compared to if the UK and EU had failed to reach an agreement, is greater for manufacturing than for other sectors. This is mainly because in the event of no deal, the EU would have imposed high tariffs on some UK-manufactured goods. However, manufacturers are still likely to be badly affected by non-tariff barriers, such as checks and regulatory hurdles, which will make it more difficult for them to import inputs from the EU and to sell their final product to the EU. Not all manufacturers will be affected equally, as Figure 1 shows. Manufacturing sectors like chemicals and pharmaceuticals are likely to be especially badly affected. As a member of the EU, UK-produced chemicals and pharmaceuticals were automatically deemed to comply with EU regulations but after the end of this year manufacturers will need to complete additional checks to demonstrate their compliance before being able to sell to the EU. This will be costly in terms of time and resources.

Services sectors – in particular, financial and business services – will be affected by no longer being in the single market. The trade agreement struck between the UK and EU has done little to reduce the costs they will face. One exception to this is around data – which is of great importance to much services trade – where a joint declaration made alongside the trade agreement makes clear that both sides are committed to facilitating cross-border data flows (although it was not included as part of the agreement itself).

However, the impact on service sectors is especially hard to predict because it is contingent on unilateral decisions that may be made by the EU or individual member states to supplement the formal trade deal. In financial services, UK businesses will rely on the EU granting 'equivalence' to allow UK financial services providers to continue to operate in EU markets. This is not part of the UK–EU deal that has been agreed. While less formally the EU has granted equivalence for clearing,* it has not yet done so for other financial services.[13] Providers of business services, such as lawyers, will also find it harder to operate in the EU after the end of the year because EU countries will not recognise UK qualifications as equivalent to those awarded by a member state. Without such mutual recognition, a UK-qualified lawyer, for example, would not be allowed to operate as a lawyer to clients in the EU.

Changes to the migration regime will make it harder to recruit staff for sectors that have relied heavily on low-skilled European workers and more expensive to employ people for those which rely on skilled European workers. The sectors with the highest fraction of employees from the European Economic Area (EEA) are food and accommodation and food and drink manufacturing.[14] The impact might be delayed by the greater availability of domestic workers as a result of the higher levels of unemployment caused by the coronavirus pandemic. However, some vacancies may still be very difficult to fill: for example, the 'Pick for Britain' campaign to hire more agriculture workers was unsuccessful.[15] The UK relies on between 70,000 and 80,000 overseas workers each year to pick crops but a drive to recruit British applicants in 2020 managed to fill only 150 farm jobs.[16]

Brexit and coronavirus affect different sectors and have different effects

Both coronavirus and (especially) Brexit have myriad effects that differ significantly by sector. Overall, we can divide sectors into five categories according to how they are affected by the two shocks:

- **Badly affected by coronavirus, relatively unaffected by Brexit.** This includes many domestically focused services like food and accommodation, arts and recreation and administrative, and support activities. These sectors cannot operate at anything like their normal capacity while public health restrictions remain in place. But they are not that reliant on cross-border trade and so are less badly affected by Brexit. One medium-term risk surrounds the food and accommodation workforce, which has historically been drawn disproportionately from EEA countries.
- **Relatively unaffected by coronavirus, badly affected by Brexit.** The chemicals sector stands out as a sector that has benefited from the pandemic but will be negatively affected by Brexit – both in the near term, due to disruption at the border, and in the longer term because of the additional regulatory burdens involved in demonstrating that products meet EU standards. Wholesale and retail trade had recovered to pre-pandemic levels by 2020 Q3 but is expected to experience a bigger than average shock from Brexit – both in the short term because of the sector's reliance on cross-border trade which could be disrupted, and in the longer

* Specifically, for Centre Counterparties (CCPs) and Central Security Depositories (CSDs).

term because of permanently higher tariff and non-tariff barriers to trading with Europe. Financial services, where people can work remotely, have been mostly unaffected by coronavirus but could lose access to EU markets after the end of the transition period.

- **Relatively unaffected by both Brexit and coronavirus.** The major non-government sector in this group is IT and media services, which do not rely too much on cross-border trade (and so are not affected by Brexit) and also do not rely on face-to-face interactions (and so have remained relatively unscathed by Covid-19).
- **Badly affected by Brexit and coronavirus.** Some sectors of manufacturing have experienced big falls in demand as a result of changing patterns of behaviour during the pandemic, including manufacturing of transport equipment (such as cars and aeroplanes). These sectors will also be relatively badly affected by non-tariff barriers as a result of Brexit.

Overall, less than a third (31%) of the economy (as measured by GDP) is likely to remain relatively unaffected by both coronavirus and the long-term effects of Brexit. And even within this minority there are some sectors that could nonetheless be adversely affected by short-term disruption in early 2021 – such as agriculture (which makes up 0.7% of the economy). This 'unaffected' group also includes public administration, which accounts for 5% of GDP.

Only 3% of the economy is relatively badly affected by both Covid-19 and Brexit. The remaining 65% is either relatively badly affected by coronavirus (42%) or Brexit (23%). In total, therefore, 69% of the economy is badly affected by at least one of Brexit and Covid-19.[*] The two shocks have such broad coverage because they are so different: the former affecting industries that rely on cross-border trade; the latter most harmful for sectors that provide in-person services, which tend to be much less reliant on such trade.

* Numbers do not sum due to rounding.

How should policy support businesses through the twin shocks?

On their own, each of coronavirus and Brexit pose difficult problems for policy makers. The goal of fiscal policy in both cases should be two-fold. First, to avoid unnecessary pain in the short term – helping businesses weather disruption to avoid liquidity problems leading to insolvencies. Second, to support longer-term economic growth by helping the economy adjust to any permanent changes, but avoiding using taxpayer money to prop up businesses that do not have a long-term future – unless such businesses are deemed to be so strategically important that they warrant ongoing public funding. In addition, the government might want to roll out more general fiscal stimulus measures to boost demand and economic output.

But the two shocks are quite different in terms of which businesses are affected and the balance of near-term and more permanent impacts. Designing policies that effectively address each shock is much harder when they need to be dealt with concurrently.

In this section, we describe how fiscal policy is and should be supporting businesses through the short-term impacts of Covid and Brexit. (We do not attempt here to examine how policy should help the economy adjust to the permanent effects of either shock.) We first provide details of the support that is already available for businesses to help them weather the coronavirus pandemic. We then consider the difficulties of designing an effective policy package to help businesses affected by short-term Brexit disruption, before outlining the main economic risks of simply allowing these firms to apply for coronavirus-related support measures. This is what will happen by default, but we provide suggestions for how the government can better target coronavirus support so that, as far as possible, it is not inappropriately used by businesses affected by Brexit.

However, while restricting access in this way would be economically desirable, it is likely to be politically very difficult and there are already signs that the government is instead simply going to allow Covid schemes to be used to cushion the end of the transition period as well. But doing that will be costly to the taxpayer and could slow down the economic restructuring that will need to happen when the UK's terms of trade with the EU change in 2021.

In addition to the sorts of fiscal policies we discuss below, the government can and should take a range of other steps to mitigate the impacts of Brexit and coronavirus in both the short and long term. For example, in the case of Brexit, the government should make all possible efforts to reduce border disruption in order to limit the short-term pain. Similarly, in the case of Covid-19, the government should tailor public health restrictions such that they effectively curb the virus' transmission while disrupting the economy as little as possible. However, we do not examine these other complementary policies in any detail here.

The current package of support to businesses during coronavirus

Since March, the broad approach taken by the Treasury has been – and continues to be – to preserve businesses and jobs while the pandemic is affecting the economy. This began as a pledge by Rishi Sunak to do "whatever it takes".[17] In effect, this has amounted to putting the economy on ice until the effects of the pandemic have passed.

The rationale for this approach is that, absent government intervention, many perfectly good businesses would have gone under and viable jobs would have been lost because of the effects of the pandemic and associated public health regulations. Given that the pandemic has always been expected to be temporary – albeit lasting many months – losing those businesses and jobs is likely to be a bad outcome for the UK. Allowing swathes of businesses to fail would have led not only to higher unemployment in the short term but probably also to unnecessary long-term damage. The failure of good businesses and the loss of viable jobs would weigh on a recovery as replacement businesses would take longer to get up and running, and employers must spend time and resources finding suitable staff to fill vacant posts again.[18]

The biggest policy to support businesses and jobs is the Coronavirus Job Retention Scheme (CJRS), also known as the furlough scheme. Through this programme, which will run at least until the end of April 2021 at its current level of generosity, the government pays 80% of employees' wages for any of their normal hours that they do not work. This is a relatively generous scheme compared to similar programmes in other countries.[19]

The government is also providing concessionary loans backed by government guarantees, with particularly generous terms for the smallest firms.[20] These are designed to help businesses to survive temporary shortfalls in cash flow during the pandemic and are open to new claims until the end of March 2021.[21] The government has also provided business grants, particularly targeted at firms in the worst affected sectors like hospitality.[*]

There are few restrictions on which businesses can apply for the ongoing coronavirus support measures. There is, therefore, a danger that some of the schemes – which are intended to tide over viable businesses – are instead used to prop up firms that are not going to be profitable even once the threat of Covid-19 recedes. To the extent that the schemes are used in that way, they will provide poor value for money.[22] The fact that a third fewer businesses failed in 2020 than in 2019 provides some evidence that these policies are indeed propping up businesses that would have failed in more normal times.[23] The size of any deadweight cost should be limited by the fact that most of the effects of Covid-19 are likely to be short term, rather than permanent.

* In March, these businesses received a business rates holiday and grant funding linked to their business rates bill. In September and October, grants were made available to businesses in similar sectors in tier two and tier three areas. Ministry of Housing, Communities and Local Government, 'Check if your retail, hospitality or leisure business is eligible for business rates relief due to coronavirus (COVID-19)', gov.uk, 18 March 2020, retrieved 22 December 2020, www.gov.uk/government/collections/financial-support-for-businesses-during-coronavirus-covid-19#business-rates-relief and HM Treasury, 'Furlough Scheme Extended and Further Economic Support announced', gov.uk, 31 October 2020, retrieved 22 December 2020, www.gov.uk/government/news/furlough-scheme-extended-and-further-economic-support-announced

However, concerns have been raised – such as by the National Audit Office – that one of the government-backed loans schemes (Bounce Back Loans) offers poor value for money because it has resulted in a large number of fraudulent applications and loans to businesses that have no prospect of paying the money back.[24]

The UK government has so far made little use of the sorts of generalised demand stimulus policies – such as VAT cuts or benefit increases – that are commonly used to cushion more normal recessions. Recessions are normally driven by a sudden shortfall in demand in the private sector, for whatever reason, while supply capacity tends to be unaffected. In those circumstances, policies to encourage businesses and consumers to spend* can be highly effective in minimising the recession.

However, the main economic hit from coronavirus has come about because of problems on the *supply* side of the economy. Businesses have not been able to operate normally and people have not been able (or have not wanted) to visit some of the places where they would normally spend money, such as bars, restaurants and on holidays. Supply problems became particularly acute in late December 2020 when the French government prohibited lorries from entering France from the UK after a new, apparently more infectious, strain of Covid-19 was detected in southern England.

Designing policy has proved difficult. While one of the government's main demand stimulus policies – Eat Out to Help Out – does seem to have encouraged more people to go to restaurants in the summer, there is now evidence that this could have contributed to a rise in infection rates.[25]

How should fiscal policy support the economy through short-term Brexit disruption?

In contrast to the economic impact of coronavirus, much of the impact of Brexit is expected to persist – that is, it is likely to permanently alter the structure of the UK economy, affecting what sort of businesses have a competitive advantage. As a result, we would expect over time to see some sectors grow and others shrink once the transition period ends. There is therefore a much greater risk in this case than in relation to Covid-19 that short-term government support could end up propping up businesses that have no viable long-term future. Using taxpayer money in this way would not only offer poor value for money but could also hamper growth by delaying economic restructuring.**

Therefore, while there is a need for the government to help some businesses cope with the short-term disruption that is likely to accompany the end of the transition period, there should be a much greater effort (than there is with Covid-19 support) to ensure that any such measures are carefully targeted only at those businesses that have a long-term future, rather than being open to all.

* This is often done either by boosting the incomes of those most likely to spend (such as low-income households) or incentivising spending now rather than later (such as through a temporary VAT cut or a temporary increase in the level of business investment that can be offset against corporate taxes).

** Even those economists who expect Brexit will have a positive effect on the economy expect it will trigger some kind of sectoral reallocation as the UK economy focuses on its new relative strengths. See Economists for Free Trade, 'Brexit could boost UK economy by £135 billion, say top economists', [no date], retrieved 22 December 2020, www.economistsforfreetrade.com/News/brexit-could-boost-uk-economy-by-135-billion-say-top-economists

As shown in an October 2019 Institute for Government paper, *Bailout for Business in a No-deal Brexit,*[26] there are several reasons viable businesses might nonetheless suffer severe short-term impacts. These include:

- Exceptional border disruption leading to delays in the import of inputs or the export of outputs, causing temporary cash flow problems and/or forcing businesses out of action temporarily.
- The need for a one-off overhaul of supply chains.

Policy makers should support businesses through these problems, provided the issues are indeed short term. However, they should ideally do so without also supporting businesses that face major medium-term problems that make them unviable. Designing a policy that would perfectly target the former group but not the latter is almost impossible; many of the businesses which are worst affected by the short-term problems are likely to be the same ones whose medium-term competitiveness has declined due to Brexit. However, there are approaches the government could take to targeting policy in this way. These imply a far more targeted and rather different package of support for businesses facing short-term Brexit disruption than the sorts of measures that are available to help firms weather the Covid-19 pandemic.

For example, again in our 2019 report, we recommended that the government should offer loans to businesses affected by short-term Brexit disruption. However, the structure of these loans would ideally be different from those schemes that have been introduced to deal with Covid: to ensure these loans are only given to firms with a long-term future, businesses should be asked to show a credible plan for recovery in order to qualify – that is, to prove that the short-term problem they face is one of cash flow rather than being more endemic. As far as possible, these schemes would also retain a role for the banking sector to assess the viability of businesses and the new loans should not be preferred to the ordinary loans that would be offered by banks, meaning that use of the new schemes should come with a fee.

The government should, therefore, impose tighter restrictions on existing Covid-19 measures and find other ways of ensuring that the subset of firms that are long-term viable but facing short-term Brexit disruption are helped.

In practice, doing this is likely to prove very difficult politically, because it would mean reducing the generosity of support for businesses which may be laying workers off or going bankrupt. However, it is worth remembering that in the absence of coronavirus the government would never have proposed introducing widely available, cheap government-guaranteed Covid loans or schemes like the CJRS to handle Brexit disruption. When the government was contemplating a no-deal Brexit back in 2019, the Treasury had plans for so-called 'Operation Kingfisher' – although the full details of this have never been published, it appears to have entailed no more than targeted support for individual businesses that the government had identified as in need of help.[27] Allowing the Covid-19 schemes to be used by Brexit-affected businesses will result in poor value for taxpayer money and possible economic damage through delayed 'churn' of businesses.

Impose additional restrictions on coronavirus support measures

As it stands, both the CJRS and the Covid-19 loan schemes will remain open to new applicants in the first quarter of 2021. There are currently no plans to introduce any requirement that the employer or business has used the scheme before. All the schemes are still on generous terms: the business loans for small and medium-sized businesses offer six months with no interest payments while the CJRS requires only minimal employer contribution. The business loans do require that a business has been "adversely affected by coronavirus" – but this could be interpreted as a fairly minimal test (most sectors' GDP has fallen at least a little this year). There is no similar condition for applying for the CJRS. As a result, many businesses affected by the end of the transition period could easily make use of these programmes. They might do so hoping that short-term disruption will ease, even though for many their jobs or businesses will not become viable again.

To help ensure that the coronavirus support measures are not inappropriately used to prop up businesses whose competitiveness is undermined by Brexit, the government should:[*]

- **Adopt a sectoral approach to support.** This report has shown that the sectors affected by Brexit and Covid-19 are different. Sectoral targeting would therefore go a long way to supporting sectors that cannot operate normally due to Covid-19 restrictions (in particular, hospitality, arts and recreation and aviation) without supporting unviable jobs in other industries. Even without Brexit looming, this approach has merit and was recommended in a recent Institute for Government paper.[28] It is not possible to identify all badly affected businesses perfectly via this approach, but it would lead to much better targeted support.

- **End the schemes earlier than planned.** The government has now committed to continuing with the CJRS and the loan schemes in some form until April – effectively ruling out this option unless the chancellor U-turns on this announcement or imposes new criteria to qualify for the programmes.

- **Restrict access to the schemes only to those applicants who have already made use of them.** If the CJRS remains in place, the chancellor could seek to target it and other schemes more effectively by leaving them open only for those who have applied to them before. Between July and October, the CJRS was only open to employees who had been furloughed before 10 June. However, it is now open to new applicants. If the scheme were to close again to new applicants before January, this would limit the number of Brexit-related furloughs. This approach will be less effective if public health restrictions become tighter in 2021 than they have been in 2020 because such new restrictions could cause problems for businesses that have not needed to make use of the furlough scheme already.

* The government has been criticised for failing to do enough to support some groups through the Covid crisis – such as company owner-managers and some self-employed people. Our proposals here do not preclude the government from introducing new schemes to help previously excluded groups. However, any such schemes should be carefully targeted at those groups.

- **Impose stricter eligibility requirements.** The business loans require that a firm shows that it has been "adversely affected by coronavirus," but this test could be made stronger and a test along similar lines could be imposed to qualify for the CJRS. The wage support schemes in some other countries, for example, require that a business's turnover has fallen by at least a certain amount to be eligible for the scheme.[29] The UK government could, for instance, keep the CJRS and the loan schemes open only to businesses whose turnover in 2020 Q3 or 2020 Q4 was well below its level the previous year (say, 10% below). The Job Support Scheme, which was due to replace the CJRS before that scheme was extended at the end of October, did have a turnover test for large businesses but the CJRS still does not. One major downside of this approach would be the additional administrative burden of assessing claims on this basis. These costs should be weighed against the likely deadweight cost of allowing potentially large numbers of businesses whose profitability is undermined by Brexit to make claims on these schemes.

Introduce new schemes to help with short-term Brexit disruption

To help businesses cope with immediate disruption caused by Brexit, the government should:

- Ideally, **introduce new government-backed loans for businesses, as the earlier report, *Bailout for Business in a No-deal Brexit*, recommended.** Such loans should retain a role for the banking sector to assess the viability of businesses and the new loans should not be preferred to the ordinary loans that would be offered by banks, meaning that use of the new schemes should come with a fee. Alternatively, for speed and ease, the government could allow these businesses to apply for Covid loans. However, they should be required to show a credible plan for recovery in order to qualify – that is, to prove that the short-term problem they face is one of cash flow rather than being more endemic.

- **Extend tax payment deferrals to ease cash flow constraints.** The government has allowed businesses to delay the payment of VAT to help ease liquidity constraints caused by Covid-19. As it stands, VAT deferred from mid-2020 will be due by 31 March 2021. This could be extended further, or 2021 payments could be deferred, to help businesses affected in the short term by Brexit.

The government may also want to offer further tailored support of the sort envisaged in so-called 'Operation Kingfisher' back in 2019. This plan, devised ahead of the potential no-deal exit in 2019, was supposedly designed to help businesses that the government had identified as in need of support. However, neither a list of businesses nor the criteria for providing support was published. If the government were to implement a similar sort of programme of tailored support, it should be clear what the criteria for offering assistance are.

General demand stimulus is likely to be less effective than normal

When the economy is weak, general demand stimulus – designed to encourage consumer spending and business investment – is often an effective approach to reducing the depth of a recession. If economic disruption in the new year leads to a big increase in uncertainty, a fall in consumer confidence and a reluctance to spend as a result, demand stimulus policies might be appropriate. Evidence suggests that the most effective stimulus policies are those that strongly encourage people to spend money now – such as increasing benefit payments to the lowest income families and temporarily cutting VAT.

However, in the absence of a big fall in consumer confidence these policies will not be effective. Business investment will probably be low but additional incentives to invest are unlikely to be sufficient to offset the high level of uncertainty that businesses face from Covid-19 and Brexit, which makes delaying investment the rational choice. More importantly, both Brexit and coronavirus will affect the supply side of the economy in the new year, restricting how businesses can operate. Encouraging more consumer spending is not the answer when the problem is supply-chain disruption limiting what is available for consumers to buy.

Fiscal policy is likely to be most effective by supporting businesses to weather supply-side disruption – as we recommend here – rather than stimulating demand.

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December 2020

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