It's time for a recovery plan

Firms in every country are reeling from the inability to do business as usual. To make things worse, many sectors see collapsed demand and economic uncertainty stretching months, if not years. Governments rightly focus on dealing with the health crisis first, and only then on the recovery of the economy once the immediate danger of the pandemic is over.

In the meantime, businesses are rapidly running out of cash. A third of Canadian firms say they can last less than another month without government support. A further third of companies will have no liquidity in three months. In the United States, the results are troubling too. Half of small US firms – these with less than 500 employees – have cash reserves for less than a month, and another quarter of businesses may run out of cash in two months. For service industries, the period to illiquidity is even shorter. Restaurants, for example, have only 16 days of cash on hand.

Rich countries' firms are not alone in facing liquidity problems. New analyses in two middle-income countries in Latin America – Colombia and Peru – show similar patterns. Retail businesses have savings from last year's profits to last another two months, construction companies – up to three months, manufacturing businesses – up to 5 months.

This breathing period is extended with government programs already in place to support worker retention through subsidising jobs, freezing interest payment on loans, and extending new bank credit. This extension differs across industries – it helps labour-intensive sectors more; firms with established lines of credit benefit more as well. Still, other payments – like rent and cost of materials – are weighing on businesses. Government subsidies buy companies some time, but a recovery plan for firms is needed, as described in our previous blog here.

The recovery plan

Governments can establish a loan program for struggling businesses that builds on top of the recently-created government subsidy schemes for job retention. The program covers all businesses, regardless of size or sector. It is administratively simple: topping up companies' revenues up to 80% of their last year's revenues for the same quarter. Companies can opt into the recovery plan if they can demonstrate a decline in sales revenue of, say, 50% relative to the same quarter last year. These declines can be affirmed at a later stage by the tax authorities, as they have access to the company's profit and income statements.

As a priority, the proceeds of this interest-free loan first go towards paying salaries. The goal is to preserve the franchise value of firms, until the day when the economy comes back on track.

To last six months beyond health crisis

The recovery plan would support payments through one half-year beyond the quarter in which the government lifts the health emergency declaration. Thus, if the government lifts that declaration on June 15, payments under the recovery plan would be made through the fourth quarter of 2020. If the government lifts the declaration on July 15, payments would be made through the first quarter on 2021.

This proposal has an in-built fiscal benefit: the cost of the payments will automatically diminish as the economy improves, because the size of the payment is tied to the size of the decline in the individual firms' revenues in each quarter relative to its revenues in the same quarter a year earlier. When the economy comes back, the size of the payments will diminish correspondingly.

How much would the plan cost?

The plan will incur significant cost. An actual example with data from the United States is as follows. In the United Sates, private sector worker compensation is 49% of GDP. If we assume that the recovery plan will on average top up half of lost revenue for the whole private economy for two quarters, and bearing in mind the 80 per cent upper threshold, the plan would cost 7-8 percentage points of GDP.

The proposed recovery plan will reduce the need to expand unemployment insurance, as fewer people would resort to it. The net cost is hence significantly smaller, about half as large, or around 4-5 percentage points of GDP, in the example using US data. This is still a sizeable cost to the government coffers.

How to prevent abuse?

Companies may have the incentive to under-report revenue and join the recovery plan. To prevent such abuse, the plan can be set up as a 30-year interest-free loan. Loans will be given with some measure of personal guarantees, a method successfully used in the United Kingdom during the previous financial crisis.

Some firms will go bankrupt after the plan is finished, thus being unable to pay. There is benefit still: at that point employees are in a better position to find new jobs, as the economy would have rebounded. In these calmer times, the government will decide how to handle such cases.

Also by Erica Bosio and Simeon Djankov on supporting the economy after coronavirus:

How to restart the economy after Covid-19

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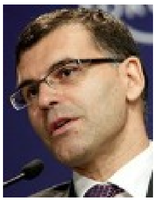

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