ICAEW
REPRESENTATION 13/21

ECONOMIC IMPACT OF CORONAVIRUS (THIRD SUBMISSION)

Issued 29 January 2020

ICAEW welcomes this third opportunity to provide written evidence to the Economic Impact of Coronavirus inquiry opened by the Treasury Committee on 6 November 2020, a copy of the call for evidence is available from this link.

In this third submission to the committee we reflect on the effect of the government's support measures on the economy and suggest where further attention is needed. In particular:

- the coverage of government support measures;
- further support that may be offered through the tax system;
- dealing with the business rates cliff edge in April 2021;
- how the restructuring of non-performing business lending might be approached; and
- the need for clarity around the future system of state aid.

We also explore the implications of the very high levels of indebtedness in the UK economy.

ICAEW's Technical Policy set out in this response has been informed by ICAEW's faculties and communities - recognised internationally as a source of expertise on specialist issues in their areas – and through strong engagement during the present crisis with ICAEW Chartered Accountants in business and practice.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 186,500 chartered accountant members and students around the world. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

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1. We are responding to the Treasury Select Committee's further call for evidence on the economic impact of coronavirus.
2. Our points on areas where government policy might go further are stated as of 17.00 on 29 January 2021, but we are aware that many of them are under active consideration by government and might be acted upon in the near future. ICAEW is a body whose members (1) are accountable under a code of ethics; and (2) have unequalled access to all sizes of UK businesses and organisations. In that context we have been seeking to play and want to play a constructive role in supporting government and would be willing to provide further detail in understanding any of the issues raised in this response.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: To what extent do Government measures protect viable jobs in the future and reduce the risk of long-term unemployment?

3. National Statistics data shows that the Coronavirus Job Retention Scheme (CJRS) has played an important role in supporting the income of large numbers of people during the pandemic and in enabling businesses to retain many workers who would otherwise have been laid off. This will be helpful to those businesses when activities pick back up. The speed and scale of the CJRS roll-out at the beginning of the pandemic was impressive and its support a life-line to many. Indeed, many ICAEW members in business hailed it as the single most effective government support policy.
4. We understand the primary purpose of the scheme initially was to support lockdown, allowing businesses facing an immediate lockdown to retain staff. As the summer progressed and the scheme changed to enable flexible furlough, the scheme evolved to protect the job market by spreading redundancies as businesses emerged from lockdown. Rather than a high number of newly unemployed all in a day, it has been spread out over months.
5. With many businesses closed or curtailed due to lockdown it is very difficult to conclude how many of the jobs protected are no longer viable. That depends on multiple uncertain factors. In any case, job retention support was designed to be temporary, while the economy was restricted by the government and employees were encouraged to stay at home. If government is seeking to retain the most viable jobs, the current exclusions that restrict CJRS for recent hires could be reconsidered. Posts recruited during the pandemic might be expected to be particularly important to businesses.
6. At the very skilled end of the furlough spectrum, we have heard from members that hard hit sectors such as aerospace are losing skilled workers that were furloughed to less hard hit sectors - which could hamper that sector's ability to recover. One member in shipping from Wales commented "Furlough has meant that skilled staff are losing their skills during time off so are job hunting".
7. As the lockdowns lift and the government moves to wind-down CJRS it could look at improving the apprenticeship scheme. These schemes by their nature focus on equipping employees with new skills and could play an important role on retraining – which may be required at pace and at scale. It would therefore be valuable to start working on this now.
8. Furthermore, the costs of returning staff to work cannot be underestimated - for example, if PPE is required. One member of ICAEW's East Midlands Regional Strategy Board has said that the lack of government financial support for these costs was in contrast to the amount spent on other schemes, so financial support and clear guidance on getting people back to physical work is key to protecting viable jobs.
9. It is worth noting that not all jobs will be retained, and some of those lost will be due to greater efficiencies. As one example, a member from the south of England in manufacturing has said that furlough has made them rethink the levels of staffing they will need in the future – this is a view we have heard country-wide and across many sectors. Therefore, new job creation and a comprehensive retraining policy will be key to reducing the risk of long-term unemployment, alongside the current support schemes.

Question 2: To what extent are Government measures value for money for the taxpayer?

10. While the economy remains in lockdown it is too early to gauge the long-term effects of the measures government has taken to support the economy. Inevitably, given the economy-wide effect of the restrictions, very broad support has been necessary. The return on this support depends to a large extent how quickly and fully activities that have been paused in the economy can return to life. What is clear is that levels of company insolvencies in 2020 have been running below their 2019 levels and this reflects the extensive support provided across the economy. As one member in Practice from the Midlands said, “Companies that I expected to be busy in January 2020 have survived through the year so far using government funding options; they’ve managed to limp on using furloughing and loans”. However, as lockdowns continue many businesses are under intense cash flow pressures with buffers having run down.

11. Another way of assessing value to the taxpayer is to consider the extent to which government support has been misused. The Public Accounts Committee has investigated losses in the government sponsored loan schemes, which is estimated in their report at £15bn to £26bn. They suggest that the majority of this amount is due to credit losses, but note that government currently lacks the data to assess the level of fraud within these schemes. As it stands, the banks will need to work through these non-performing loans and apply appropriate resolution measures. Given the very large number of loans advanced and the estimates of losses made, this will be a huge task and may require new measures that can be applied at scale. The role of government in this has not yet been clarified – but all of the actions taken as this debt is unwound will have implications for the cost for the taxpayer. Robust action will be needed against those who have misused these schemes. Equally, for many businesses struggling to meet debt repayments, fair treatment by lenders will be essential.

12. It is worth noting that public pressure and corporate responsibility has helped drive greater value for money - with many businesses quite publicly repaying government support they had received. We also heard from members instances where they opted not to take support as they had sufficient reserves; one member from the North East in engineering said that they “self-furloughed” rather than using the government scheme so they wouldn’t be restricted on paying dividends.

Question 3: How effective is the Government support to businesses and individuals across different regions and sectors? Does the effectiveness of the Government support vary across different regions?

13. We have provided specific examples in the questions above.

Question 4: What lessons can be learnt from the different approaches undertaken by the nations in the UK to combatting the coronavirus?

14. We do not have any evidence to add on this point.

Question 5: What impact will a second lockdown have on the economy? How should the Government best support the economy if intermittent lockdowns become a feature over the next year?

15. The impact of lockdowns on the economy overall can be tracked from the National Statistics, but these do not reveal the implications for individual businesses. The government’s support packages have tried to anticipate this by targeting sectors that have been particularly badly affected, as well as offering broad based measures to support jobs, self-employment and lending across the economy. The core of the strategy should be to sustain this support while lockdowns are in place and economic activity restricted by the government.

16. It is important that the packages are kept under continual review to ensure they remain right for current conditions. We have suggested some areas for consideration in our letter to the Financial Secretary in advance of Budget 2021. Key issues include:

- Coverage of support measures: the committee's interim report highlighted gaps in the government support provided, which collectively affect a large number of people. We note that recommendations in the interim report have not been implemented by government and that coverage of the support schemes remains broadly as set earlier in 2020. While the broad and extensive government support provided has enabled many businesses to tide themselves over during the lockdown, questions will inevitably be raised about the equity of the schemes' coverage and will continue while restrictions remain in place. They should not be forgotten as government makes decisions about sustaining and extending support.

  As well as remaining mindful of those who do not qualify for the support schemes, it is also important to keep coverage under review for changes with the passage of time. For example, eligibility for CJRS currently depends on employment at 30 October. More recent hires might be vital to business continuity yet not supported in CJRS.

- Further support through the tax system: While businesses are restricted in their activities it is also important that the tax system does not exacerbate the difficulties. We recommend that welcome tax easements already put in place are continued and extended. There are a number of other circumstances where relaxations are needed.

  For example, employees can qualify for tax relief on travel and subsistence expenses where they work from a temporary workplace. But this is subject to a 24 month maximum. The 24 month clock could be stopped where an employee is prevented from working at a temporary workplace for COVID-19 related reasons. There are similar 'clocks' for tax purposes that may affect ex-patriate employees trapped in the UK. Finding that these 'clocks' have inadvertently run down during lockdown might restrict businesses access to staff in the recovery.

  The carry back of company trading losses might also be extended to say three years rather than 12 months, similar to the changes made temporarily in 2008.

  Other potential COVID-19 easements that we believe need review in the light of the continuing pandemic include:

  - Payment and filing deadlines
  - HMRC discretion on time limits including:
  - Extension of 31 March 2021 deadline for exemption from SDLT on properties worth up to £500,000 (given the difficulty in completing transactions by that deadline)
  - VAT reduced rate for leisure, hospitality, catering etc: consider extending beyond 31 March 2021

- Business rates 'cliff edge' in April 2021. It was inevitable that business rates had to be suspended for large parts of the economy at the outset of the crisis, as its failure to flex rapidly enough with economic conditions would have exacerbated hardship. Its reintroduction in April this year will bring these issues to the fore and urgent consideration needs to be given of the impact of this cliff-edge on businesses that may have only very recently reopened at that point. In our response to the Treasury call for evidence we also pointed out that after continual rises since the 1990s the 'multiplier' is now simply too high. Although it has been frozen in the spending review it remains at more than 50p for each £1 of rateable value.

- Appropriate and targeted mix of continued forbearance and recapitalisation: there is now a very large, and growing amount of likely unstainable debt in the UK economy. Inevitably, in due course some of this debt will need to be restructured, which will likely involve a call on the government's guarantee. We have seen little indication from government to date for how this process will be managed. With the very large number of loans advanced an organised approach to debt restructuring is likely to be necessary.

  We believe that an immediate government focus must be to lead a joint public/private strategy of continued business support and carefully targeted forbearance.

Government should, of course, start to consider longer-term ideas for how to support this debt burden and ICAEW is prepared to help with and support this. Government should consider how this should happen, what support it will need to provide. That might, for example, include considering its transfer from the banks' balance sheets into a vehicle designed for this purpose. Innovative solutions will be necessary. For example, AFME and PwC have published proposals for recapitalising EU businesses, including an equity-like instrument that preserves corporate control. Nevertheless, in designing these solutions government should consider carefully the borrowers' perspective. Decisions will need to be taken about when and how to communicate to borrowers and what triggers will push loans into restructuring. It's essential that these are objective, certain and simple.

- State aid: Government made changes at the end of July to resolve the 'undertaking in difficulty' restriction for SMEs. However, despite the UK's exit from the EU we understand the existing state aid restrictions continue to apply. We now need clarity about the state aid framework that will apply to businesses going forward.

Question 6: What changes to the economy are now permanent?

- ***What difference will the discovery of a vaccine and/or treatment make?***
- ***Will behavioural changes such as working from home necessitate structural changes, whether or not a vaccine is discovered?***

17. We do not have any evidence of the permanent or longer-term effects of the pandemic on the economy. The level of government lockdown restrictions has shaped what businesses have been able to do and we have seen in 2020 businesses adapt to some extent as restrictions have been successively tightened and released. Many types of businesses have been unable to operate fully, or at all during lockdown, but there is not necessarily a reason to believe they cannot return to normal operation once restrictions are lifted.
18. We do not speculate on which sectors may see permanent changes, but we make some comments below to help the committee evaluate their implications. While businesses will try to adapt to the new environment, there will be accounting implications of change that could, at least temporarily affect their profitability and ability to attract finance. In particular many businesses will find they have assets that they can no longer use, or which generate less revenue, or they may find they have contracts they cannot fulfil.
19. This raises the risk of 'capital destruction'; even if a business is viable in the future once conditions return to normal, to survive they will still need to be able to meet their obligations as they fall due. After a prolonged period of shutdown and/or with higher debts to service they may find they are no longer able to do so and then default or fail as a result. That then has repercussions for their creditors and owners who find their assets impaired – indeed they may need to recognise that their assets have reduced in value even before those businesses fail. ICAEW has provided resources to help businesses understand these issues and we continue to draw our members' attention to the importance of robust accounting for 2020.
20. The government's support packages have been aimed at averting this chain reaction, and judging by the insolvency statistics have been successful so far. Company insolvencies for 2020 have been running some level below the comparable figures for 2019. While there are a number of factors that have restricted insolvency proceedings, nonetheless, it is apparent that we have yet to see a significant wave of business failure. However, while the future remains uncertain and with so much reliant on continued government support, that position could reverse rapidly.

Question 7: How large a problem is corporate indebtedness? How effectively did the financial sector give assistance to businesses?

21. The December 2020 Bank of England Financial Stability Report states that UK businesses have raised over £77 billion of additional financing since March 2020. It also highlights that across the economy businesses expect a cash flow deficit of up to £180 billion for the 2020-

21 financial year, or around £90 billion once cash deposits are taken into account. The 2021 Bank of England stress test is testing resilience against a scenario of credit losses of £800bn over 2020-22. These are huge figures and are mounting as lockdown continues. Many individual businesses, having survived so far, will run out of cash soon unless conditions ease. Acute concerns include having to meet rent payments, which in some cases may have been deferred so far, the return of business rates in April 2021, and meeting tax payments. The Bank of England stress test assumes the government schemes will close as announced in March 2021.

22. The reality is that very many businesses will be facing higher leverage for years to come. The cost of servicing this debt will rapidly increase as the government interest and fee subsidy is withdrawn. The only long term solution is a rapid and sustained economic recovery and how the debt burden is managed will depend largely on the strength of this.

23. Nevertheless, as we illustrate in this response, there is a high level of interlinkage between these different factors. During the financial crisis this was well known as 'contagion', which referred to the transference of risks from one financial institution to another to create system wide failure. The issue of contagion plays out differently in the wider context of the whole economy, but the point is that failure, or underperformance, in one business has implications for others. That means that attention needs to be given to a coordinated response, where different parts of the system positively reinforce each other. Just one example is that higher leverage exposes businesses more extensively to the future path of interest rates. In managing these issues government should also consider:

- Fair treatment by lenders: Experience in the 2008 financial crisis shows how the risk of mistreatment of business borrowers rises as these businesses become stressed and dependent on finance lines. Opportunities for misconduct are therefore significantly heightened and regulators will need to exercise extra vigilance. At the same time there will be significant pressures stemming from the volume of distressed debt that is expected. This may make it difficult to provide tailored and appropriate solutions for individual circumstances, increasing the risk that individual outcomes are unfair. There will need to significant attention to these risks. As an initial measure government could consider the effectiveness of current regulatory measures to protect small businesses.
- Importance of good financial management: Individual businesses cannot influence the economic environment, but they can control resources within their business. Consequently, the value of good financial management significantly increases, even while finance staff may have limited capacity due to sickness and increasing demands. ICAEW has been mindful of this and has been making resources available free-of-charge throughout the pandemic to help equip businesses with the skills to survive. Our Business Finance Guide is one example. ICAEW's Business Advice Service enables businesses to access a free one hour consultation with a qualified professional. Government could help build awareness of this scheme.
- Implications of operating with high leverage: All other things being equal, businesses with higher indebtedness will need higher margins to be able to pay the debt 'coupon' and still return the same earnings. That could be inflationary, but price increases will depend on the market and such pressures will also affect the cost base. Alternatively and often more realistically, they will have to shift to higher value activities and/or up the risk curve. Higher risk activities will put more onus on having good operational and financial controls. It could also have an impact on business failure rates.
- Other issues: Levels of indebtedness are usually measured in proportion to the amount of equity in a business – known as leverage. Where leverage is higher, businesses may have fewer resources to generate income to meet debt repayments. Dividend payments reduce equity, so businesses also therefore need to manage these. Multiplied across the economy, a reduction in dividends equates to less cash flowing into the economy and may also impact company valuations. The amount of dividends that can be paid depends on the level of 'distributable profits'. Given the importance of these factors to the economy, ICAEW has published an Introduction to the law on

dividends to help company directors and others understand the factors that govern distributions.

We also note that the reintroduction of crown preference in December 2020 has increased the risk to lenders. This measure elevates the position of HMRC in the creditor hierarchy above creditors with a floating charge. It is possible that this will have an impact on the pricing and availability of credit and government should keep this under review.

Question 8: What improvements can be made to institutions to ensure that responses to crises like these are more robust in the future and policy makers have the data they need? What further analysis should the Government do and make transparent?

24. We have no further evidence on this point at this stage.

Question 9: What are the consequences of high national debt? What should the new fiscal rules be?

25. We have no further evidence on this point at this stage.

Question 10: The Spending Review was originally due in the Autumn 2019 but has now been postponed for more than a year. How robust is it in times of crisis?

26. Comprehensive Spending Reviews have been a significant contributor to improving the quality of financial management in the public sector by providing departments with the ability to plan activities across multiple years and giving them the confidence to invest.
27. Unfortunately, in the last three years successive Spending Reviews have been postponed and replaced with stopgap spending rounds, making it that much more difficult for departments to plan their core activities. In the event, departments have been distracted from the crisis with a need to focus on continually re-negotiating budgetary allocations for their core activities. This has also made it more difficult for the Government to take a strategic approach to how public resources can best be utilised.
28. Rather than three-year Spending Reviews every five years, it might be better to have five-year Spending Reviews every three years.

Question 11: How effectively did the Government work with the Bank of England? Was fiscal and monetary policy well-co-ordinated? Do there need to be changes to the monetary and fiscal framework?

29. The Government and the Bank of England appear to have worked effectively together to co-ordinate fiscal and monetary policy. In particular, the monetary framework has appeared to work well, with transparency in analysis and decision-making through the publication of minutes of the Monetary Policy Committee. The Debt Management Office responded quickly to accelerate the pace and scale of gilt issuance and communicated well with debt markets in doing so. HM Treasury was able to implement a wide range of fiscal interventions in response to the emerging pandemic and has adapted that response as the situation has evolved.
30. However, the fiscal framework itself has not been effective, with a lack of clarity over the financial implications of decisions made throughout the crisis and a failure to co-ordinate with the Office for Budget Responsibility over the course of the summer to ensure fiscal forecasts were as informed as possible. The quality and transparency of financial analysis published by the Treasury and the Office for National Statistics remains inadequate with, for example, regular revisions in the tens of billions of pounds to monthly public finance numbers published during the course of the pandemic. This is not conducive to good financial decision making.
31. The Government should rethink its approach to fiscal strategy, and not just because of the inevitable suspension of medium-term fiscal rules and targets during the financial crisis just

over a decade ago and the pandemic today. There is need to incorporate the likelihood of adverse fiscal events occurring over time into fiscal planning, with an objecting of increasing the resilience of the public finances to weathering a range of potential crises that could occur in the future.

32. There continues to be a lack of clarity in how the UK will be able to fund public liabilities and financial commitments that has only been exacerbated by the additional debt taken on during the pandemic. A long-term fiscal strategy is needed to put the public finances onto a sustainable path.

Question 12: What are the productivity challenges in the wake of the coronavirus crisis?

- ***How has the crisis impacted on innovation and technological development? What problems could technology solve and what problems will it cause?***

33. The committee could refer to a recent study by the Enterprise Research Centre, which is partly funded by BEIS and innovate UK. Members have expressed concerns to us around the impact of the loss of essential (soft) skills from remote working for over 12 months, particularly for junior staff and those newly entering the work place, this is a real concern and will negatively affect productivity.