Are standard macro policies enough to deal with the economic fallout from a global pandemic?

By Thomas Drechsel & Sebnem Kalemli-Ozcan, March 17, 2020

The Covid-19 outbreak is a health shock rather than a standard slowdown in economic activity. It is materializing as an unavoidable temporary economic paralysis, and its consequences will likely amount to a severe contraction of the global economy and a global financial crisis. The collective attempts to avoid the spread of the virus are needed desperately, but such containment action will also likely lead to an almost full suspension of economic activity in many parts of the economy.

The recourse to standard expansionary fiscal and monetary policies may not be effective right now. Textbook expansionary policies try to stimulate demand, but people who simply stay at home are not currently responsive to such stimulus, which may in fact reduce these policies’ fire-power when it is needed later on. A “war time” economic thinking should dictate that the virus is the external enemy and needs to be defeated at all costs to recover an economy that functions in a regular way. It calls for a host of targeted policies, as suggested by the IMF Chief Economist Gita Gopinath early on.¹

Part of this thinking is about figuring out the essence of the shock and its economic transmission in the short run. For macroeconomists, the crisis appears to currently materialize both as a demand shock and a supply disruption. It is also important to pin down whether the shock will lead to a liquidity or a solvency problem for the real sector.

A pure liquidity problem arises when one learns that the return coming today will instead come tomorrow; all that is needed is to manage liquidity accordingly, for example through a loan. A pure solvency problem is associated with a lack of long-term viability. Solvency issues do likely not apply to the majority the business affected by the current paralysis. Once the epidemic is over and the economy recovers, most businesses should be as profitable as before. SMEs, however, may now go bankrupt. The effects from such default are well known: lay-offs, NPLs, weaker banks, weaker demand, sluggish investment, and a sluggish recovery.

Thus, the losses of the economic paralysis should be shared. Preserving the medium and long term continuity of businesses is important for the society.

How to address the liquidity squeeze faced by small businesses?

Several governments have already taken decisive action to address companies’ looming liquidity shortfalls. As a notable example, the German government was quick to legislate a package of economic measures, which includes tax deferrals, as well as unlimited access to loans via Germany’s state owned development bank KfW.²

While these policies are extremely welcome and legislation was rapid, there might still be an issue on the magnitude and timely implementation. First, tax deferrals will allow business to delay payment of

¹ See details here: [https://voxeu.org/content/limiting-economic-fallout-coronavirus-large-targeted-policies](https://voxeu.org/content/limiting-economic-fallout-coronavirus-large-targeted-policies)
² See details here: [https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2020/03/2020-03-13-download-en.pdf?__blob=publicationFile&v=2](https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2020/03/2020-03-13-download-en.pdf?__blob=publicationFile&v=2)
outstanding tax liabilities. There is large variation across firms in how the magnitude of these liabilities compares to the dramatic reduction in revenues from the contraction in economic activity.

Second, it is unclear whether the administrative process involved in asking for emergency loans can be executed timely enough. For example, will the owner of a small café or a laundry store be able get access to such an emergency loan to service outstanding payments while demand has already virtually collapsed to zero?

Alternative: An immediate negative lump sum tax for SMEs

Many firms need liquidity urgently, it is a matter of weeks or even days. What if the government provides small businesses with an immediate negative lump sum tax?

The magnitude of this government transfer could be determined as a share of the firms’ revenues in 2019 (or a share of an average over past years). How high the share should be (it could in principle be 100% or even above) would depend on how much the government is willing to spend on the program.

The negative tax could come with some conditionally, for example could require firms to hold on to their employees. Thus an alternative way of implementing it, instead of transferring the revenue, can be to transfer the entire payroll wages based on the 2019 tax filings of the firms. For the next year if the company shows lower employment, then the difference can be returned to government. It could be targeted to a subset of firms or industries, ideally to firms below a certain employment threshold such as 500 who constitute small businesses, as for these firms the implementability constraint of the existing measures, pointed out above, likely binds. As argued, it could either come as full-on transfer (pretty much making it “helicopter money”) or it could be partly reversed in later tax years, when the economy has recovered.

A negative lump sum tax can be implemented fast and translates into cash flow for businesses

A negative lump sum tax would allow a cash transfer of a magnitude that could exceed that of a deferral of existing tax liabilities. Importantly, immediate means that the government literally directly wires the money to the business’ bank account via the existing tax system infrastructure, right now! It could be done without requiring firms to do any paper work whatsoever.

In the case of the US, this may be implemented directly via the Internal Revue Service (IRS). Upon successful legislation, the IRS, which should have the required information and infrastructure, could transfer money within days, the way it would do with a standard tax refund.

The government as “buyer of last resort”

The proposal closest to ours has been advocated by Emmanuel Saez and Gabriel Zucman. We very much share their reasoning that an aggressive intervention is needed to prevent mass liquidation of businesses and mass layoffs of workers. Saez and Zucman also acknowledge that access to loans is not sufficient to provide a direct compensation of losses.

Our proposal of a negative tax has the benefit that practical implementation may be swift. For small businesses the problem is a lack of cash and time is already running out. Even if there is the political will

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to help these businesses, it is logistically tricky to actually send money to firms. Among the different institutions, it should be tax authority has the information and infrastructure needed for this. When the threat of bankruptcy is so immediate, it comes down to practical details such as having a database with the firms’ identities and bank account numbers which can be further linked to the U.S. Census database of the universe of firms.

We are aware that this is a rather blunt proposal, however we believe that out-of-the box thinking is urgently needed now. We also acknowledge that there are some parameters to be figured out, such as the type, magnitude and the universe of firms to be targeted. But the basic idea has the crucial benefit that it would directly and immediately address the disruptive liquidity needs of small businesses, where most employment occurs, and where we therefore think policy intervention currently has the most kick.

**Policy is hopefully moving in the right direction**

At today’s press conference, Treasury secretary Mnuchin mentioned that in addition to delaying payroll taxes, the US government now aims to provide cash to businesses and individuals, without getting into details. Our proposed policy of a negative lump sum tax, implemented through the IRS, can achieve exactly this in a quick manner. As we write, additional advice by macroeconomists, given with impressive dedication and at an unprecedented speed through social media, points in a similar direction, for instance by calling for a direct “liquidity life line” to European firms via loans from the EIB.\(^4\) It is clear that economists hope to see an aggressive response by policy makers, which takes their advice seriously.

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\(^4\) See this very recent piece circulated by Markus Brunnermeier, Jean-Pierre Landau, Marco Pagano and Ricardo Reis: [https://scholar.princeton.edu/sites/default/files/markus/files/covid_liquiditylifeline.pdf](https://scholar.princeton.edu/sites/default/files/markus/files/covid_liquiditylifeline.pdf)