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**Profit Related Loans for Economically Disadvantaged
Regions***

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* The views expressed are those of the authors only. The paper has been revised since its original draft of April 2003 although it was not considered necessary to update the data used to illustrate the paper's main arguments.

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ABSTRACT

There is an increasing recognition that economically disadvantaged areas do not have an inherent capacity to regenerate economic activity or to deliver automatically socially propitious outcomes. In such circumstances, there might be a strong case for public sector intervention of various types.

In what follows we a case for the provision of financial resources for the establishment or consolidation of community social, and other, regional enterprises. The circumstances underlying the impotence of markets to solve financing issues are explored, and some attention is given to historical attempts to address the problem. Most importantly, we outline a potential new approach for the public sector in this area.

An important and novel aspect of the exercise involves the government providing some proportion of the required finance in the form of a loan to be repaid by the enterprise only when and if the project becomes economically successful. This form of government intervention, known as income related loans, is designed to limit the extent of economic risks faced by the relevant enterprise, and has the desirable equity characteristic of repaying to taxpayers some return to their investment. Through reference to the Higher Education Contribution Scheme it is explained that the essential bases of this form of public sector approach to financing investment is well established, both conceptually and in administrative terms.

Keywords: community investment; income related loans

JEL Classifications: G18, G24, G38

*“I’m standing on the outside, looking in,
A room full of money and the born-to-win,
And no amount of work’s gonna get me through the door...”*

Cold Chisel

1. Introduction and Summary

There is an increasing recognition that, without government assistance, market economies do not always deliver the socially best outcomes in a regional context. Economically disadvantaged areas do not have an inherent capacity to regenerate economic activity or to deliver automatically socially propitious outcomes. In such circumstances, there might be a strong case for public sector intervention of various types.

At the same time, much public money has been wasted through poorly constructed schemes implemented by central government without due regard for local conditions. To be most effective, any intervention needs to be able to tap into and build upon local enterprise and drive.

In what follows we consider the background to this issue with respect to the provision of financial resources for the establishment or consolidation of community social, and other, regional enterprises. The circumstances underlying the impotence of markets to solve financing issues are explored, and some attention is given to historical attempts to address the problem. Most importantly, we outline a potential new approach for the public sector in this area.

The suggested program involves a partnership between three parties: financial institutions, the public sector and the specific social or private enterprise. It is explained that the nature of private investment in a regional context might require the involvement of each party, and a particular form of this partnership is examined. The steps involving the way in which the scheme might be instituted are suggested.

An important and novel aspect of the exercise involves the government providing some proportion of the required finance in the form of a loan to be repaid by the enterprise only when and if the project becomes economically successful. This form of government intervention, known as income related loans, is designed to limit the extent of economic risks faced by the relevant enterprise, and has the desirable equity characteristic of repaying to taxpayers some return to their investment. Through reference to the Higher Education Contribution Scheme it is explained that the essential

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PART A: SOME BACKGROUND ISSUES

2. Innovative Financial Assistance on a Regional Basis

There is no magic solution to generating greater economic activity in depressed or disadvantaged regions. Circumstances and the resources that may be garnered will differ. A scheme that works in one place may not work elsewhere.

Numerous studies and numerous policy initiatives have been conducted over the past few decades to address what is a major economic as well as social challenge for the community. An overriding theme is that, while governments should establish an overall policy framework, any solution will be critically dependent on local drive and enterprise.¹

Fortunately, there appears to be fertile ground in which to tap such local drive. Brian Murnane's work with the Claymore community is a frequently cited example, but there are many others in local communities and regions throughout Australia.² Such local initiative takes many forms but one particularly promising development comes under the banner of social enterprises.

Social enterprises are businesses that attempt to develop self-sustaining solutions to longstanding social problems within fractured communities. They are commonly based on business models that aim to provide returns to investors, and often entail a three-way pact between financial institutions, government and businesses partnerships and have developed. Social enterprises have sometimes emerged because larger corporations are not well suited to operate in the relevant parts of the economy.

Patrick McClure, chief executive of Mission Australia, has argued in favour of social enterprises:³

The dramatic changes of the past two decades have left many Australian communities without the traditional social networks which connect people. The growing divide between the job-rich and job-poor is just one symptom of this, but the cure runs much deeper than simply creating jobs. We need to establish a deliberate focus on community capacity-building and encouraging social entrepreneurship so communities, families and individuals are provided with opportunities to become economically and socially engaged.

¹ See especially McKinsey and Company (1994). SGS Economics and Planning (2002) provides a comprehensive review of the issues.

² See, for example, the cases discussed in McKinsey and Company (1994) or Latham (2001).

³ See Walker (2002).

The UK Department of Trade and Industry has a strategy for social enterprises,⁴ which recognises that social enterprises have an impact much broader than just financial return. The ability to show that a social enterprise is meeting both its financial and social bottom lines will be increasingly important if social enterprises are to play an expanding role in the delivery of public services.

Patricia Hewitt, UK Secretary of State for Trade and Industry, wrote in that strategy:⁵

Social enterprises are dynamic, progressive businesses that we can all learn from. They experiment and innovate, and have the advantage of being able to draw upon best practice in the voluntary sector, as well as the entrepreneurial flair that exists in the best of our companies ... this is an area where social enterprises can leverage real commercial advantage, often finding it much easier to attract and retain highly motivated staff. Crucially, social enterprises provide a mechanism for bringing excluded groups into the labour market, raising skill levels and increasing the chance of future employability. And, if we are to encourage a greater spirit of enterprise in our public services, then there is no reason why all the partners in this process should come from the mainstream private sector. There are very real opportunities, I believe, to promote social enterprise as a key component in the process of modernising and reforming our public services.

Social enterprises are best defined in terms of how profits are distributed rather than, say, the types of activities in which they are engaged. In metropolitan areas in Australia, they tend to be based around labour market issues. In regional areas, they tend to be based on efforts to regenerate what have been declining communities.

While social enterprises are a very promising approach to developing economic activity in what can be difficult regions or excluded groups in the community, other locally-based initiatives that may not fall under the banner of 'social enterprise' could also be encouraged. The spectrum runs from:

- social enterprises that may be able to bring only limited equity and other sources of funds to the project, but with a broad support base within the community; to

⁴ See <http://www.dti.gov.uk/socialenterprise/strategy.htm#summary>

⁵ See

<http://www.dti.gov.uk/socialenterprise/documenta.pdf>><http://www.dti.gov.uk/socialenterprise/documenta.pdf>

- private companies and/or individuals where the owners will have more collateral available to support the project.

The provision of adequate and appropriately vetted capital presents particular challenges for community projects and other ventures in regionally disadvantaged areas. This paper proposes a creative solution whereby Government facilitates the active involvement of financial institutions.

For any scheme to be successful, it will have to appreciate the strengths and weaknesses of how financial institutions currently operate and ensure that they have appropriate incentives to be actively involved. Accordingly, before examining the details of the proposal, the next section comments on how the financial system currently goes about lending for developing businesses. The discussion focuses on small business although many of the ideas are more generally applicable.

3. Access to Finance by Small Business

3.1 Traditional bank finance

The great benefit of financial deregulation has been that it has significantly expanded choice and the range of financial services available to customers. Many more products – and variants on those products – are accessible through much more of the community, albeit at a price.

In an extensive study of the availability of capital in the wake of the very tight financial conditions of the late 1980s, the (then) Industry Commission concluded that there was no evidence of finance being rationed in a *generalised* way other than through price.⁶ This was a significant improvement on the situation in the 1970s where the banks rationed credit across the board. Subsequent studies have similarly concluded that finance was more readily available which is not surprising given the continued innovation that has occurred.⁷

⁶ Industry Commission (1991). Also around that time, the House of Representatives Standing Committee on Finance and Public Administration (1991) formed similar views in a related inquiry in financial deregulation.

⁷ For example, the adequacy of bank lending has not registered as a primary concern in the Yellow Pages survey of small business over the past 4 years. On the other hand, Hindle and Rushworth (2002) found that while more risk capital was available, and while the high level of home ownership in Australia helped small business get finance, there were still difficulties in obtaining early stage equity finance and debt capital.

In an important sense, however, such studies do not address the key issues. The studies are unable to detect clear market failures narrowly within the banking (or financial) sector and conclude that banks in the main are responding appropriately to customer demands.

However, the principal concerns have been broader than just whether financial institutions are responding appropriately to a given set of signals. Rather, they relate to how best to bring viable projects to a stage where finance will be forthcoming and the roles of the various parties in this process (including governments and financial institutions). For example, the Industry Commission's recommendations tended to involve either improving the information flows between borrowers and lenders or providing support for potential borrowers to develop their proposals to a standard worthy of consideration for finance.

In a market economy, of course, it will be up to individuals to take the necessary action. However, there are four areas where some government encouragement and/or intervention may be warranted:

- assisting small business to become finance-ready;
- the provision of start-up capital for projects where significant external benefits are likely such as some projects based on research and development;
- attracting finance into regionally depressed areas; and
- access to finance for disadvantaged groups.

The first two of these areas will primarily involve economic objectives where the benefits extend beyond the project or business being financed. In contrast, attracting greater finance to disadvantaged regions and groups within the community can have both social and economic benefits.

The appropriate policy response to the challenges being confronted will be difficult. In essence, in the case of debt finance, the relevant financial institution may not be prepared to lend because either:

- (i) the proposal needs further development (eg a business plan, a new corporate structure, or additional management or other skills);
- (ii) the project needs additional resources, possibly from public sources if there are potentially significant external benefits from the project; and/or

- (iii) the financial institution does not have the resources, or the ability, to fully understand the nature of the project and the risks it may incur if it extends credit.

Increased competitive pressure has meant that cross-subsidisation across banking products has been largely curtailed. Consequently, banks require a cost-effective means of assessing and monitoring loans both individually and within specific areas of lending.

Where feasible, banks have already implemented streamlined screening processes. For example, banks have been willing to offer discounts over basic mortgage loans for individuals who are members of particular industry associations or employees of particular companies. Default rates for such individuals are presumably deemed to be lower than for the community as a whole and the bank does not need to embark on extensive screening and monitoring processes.

But such devices are not as readily available for small business where there is greater variation between prospective profitability. In fact, given the often limited size of the borrowings involved, it can become prohibitive to assess and closely monitor loans based on cash flow alone. Partly as a consequence, banks have tended not to develop and maintain the skills required to lend on the basis of, primarily, a close relationship with and understanding of the particular business.

Instead, small businesses – especially start-ups and small businesses that need capital to expand – rely heavily on personal funds and debt secured against the family home or another asset. The 1995 Yellow Pages survey of small business highlighted:

- small businesses seeking finance have typically sought debt rather than equity. Debt is less complicated, more readily available and does not involve an automatic lessening of control; and
- most debt takes the form of bank lending and virtually all of that debt is back by security of some form. For start-up businesses, this security is frequently the family home; for established businesses, the assets of the business can more frequently be used.

Of course, a suitable form of security makes it much easier for a financial institution to advance credit, especially if the security is in the form of the family home where

valuation is not a major issue for the bank. This is reflected in the lending rates offered to small business, now illustrated in Table 1.⁸

Table 1
Banks' Indicator Lending Rates for Small Business – Feb 2002
(per cent)

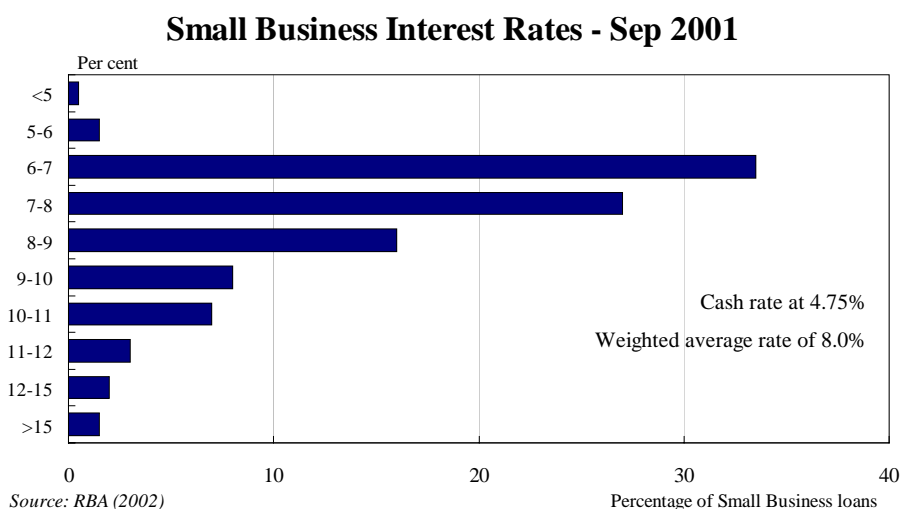
Residential secured	
Overdraft	6.80
Term loan	6.25
Other security	
Overdraft	7.50
Term loan	6.83
Cash rate	4.25

Source: RBA (2002a)

Banks do still offer *unsecured* finance to some customers under quite limited conditions. But the additional costs small businesses would have to encounter even if they wished to seek unsecured finance means that in practice a relatively small amount is extended.

Moreover, the incentive to provide quality security has seen the profile of rates applying to actual loans – rather than the indicator rates in the above table – bunch at relatively modest margins over cash. Indeed, whereas the weighted rate for small business loans was over 6 percentage points above the cash rate in 1994, the margin had come in to 3¼ percentage points over cash by 2001. Ranges in small business rates are shown in Figure 1.

Figure 1



⁸ Term loans for small business are akin to variable mortgage rates, with a term typically between 10 and

3.2 *The Commonwealth Development Bank*

The above discussion suggests that, while the lack of debt finance has progressively become a lesser constraint on small business growth, the requirement for cost-effective screening and monitoring by banks has meant that the system is heavily reliant on the quality of the security available. For social enterprises and economically disadvantaged areas, this will become an issue. In some instances there may be no security and in others it is unlikely to provide an adequate basis for the business proposition being contemplated. An alternative approach is needed.

The experience of the (now defunct) Commonwealth Development Bank provides an interesting perspective on bank lending for riskier projects. The CDB was established to provide finance for, especially, small businesses where it was deemed it would not be available “on reasonable and suitable terms and conditions”. Its Charter incorporated the following objective:⁹

In determining whether or not the finance shall be provided for a person, the Development Bank shall have regard primarily to the prospects of the operation of that person becoming, or continuing to be, successful and shall not necessarily have regard to the value of the security available in respect of that finance.

The CDB was established in the period prior to deregulation when the controls over banks resulted in lending to small business being rationed. It continued after deregulation to lend for proposals that the major trading banks found too difficult with much of its business coming from referrals from the major banks.

Moreover, it was able to do so reasonably successfully with an average return on equity between 1986 and 1991 of 8.2 per cent.¹⁰ The CDB tended to lend for longer periods and at higher rates than the major banks, but for riskier propositions. It was able to operate profitably principally because it had built up considerable skills in evaluating business operations. For example, a representative of the Australian Small Business Association observed that:

the CDB “had accountants that were not just trained in accountancy but were accountants that had been used to going into business and knowing where the key

15 years.

⁹ See page 211 Industry Commission (1991).

¹⁰ The average return on equity for the major banks over this period was between about 9½ and 12¼ per cent during this period – see Industry Commission (1991).

spots were to look at. They came into my business for one and a half weeks ... I believe that I have got a lot to thank for the approach – the way the Commonwealth Development Bank lent their money.”¹¹

In effect, to be able to lend high risk capital, the CDB had to build up specialist financial and management skills, and then apply them in a rigorous fashion. Its rejection rate tended to be around 50 per cent.

The Industry Commission recognised that these were skills that the major trading banks could not duplicate at the time. Similarly, the CDB had in its Charter the option of taking equity positions in individual companies. However, in large part because the CDB did not have these skills, it acquired only a very modest portfolio of equity positions. This field it left to the development capital funds.

Deregulation meant that the CDB was forced to take on increasingly risky propositions as the major banks were free to adjust their operations to take the cream of CDB’s customers. And with margins decreasing much further over the 1990s as outlined earlier, the CDB would have faced a very difficult task. As it was, the CDB was integrated into the CBA when the CBA was privatised.

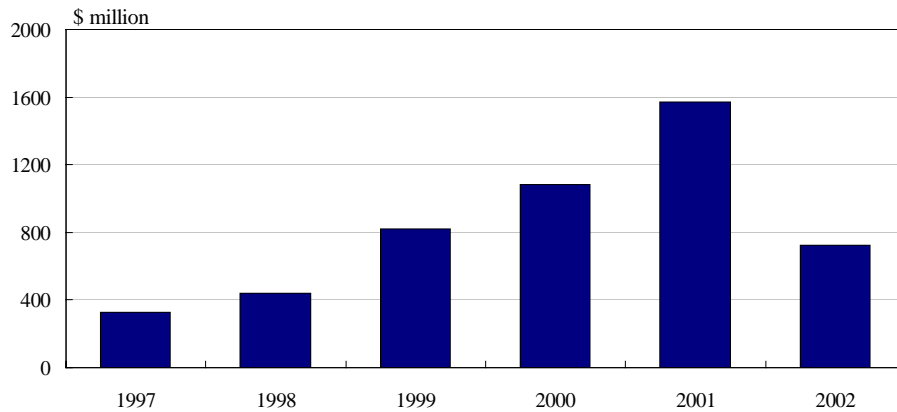
3.3 Equity capital

The focus in the above discussion has been debt and, for the most part, lending by banks. Private equity, however, can be attractive for small, new and innovative businesses, especially where collateral and a track record of profitability are limited. Thus, it should be among the suite of options that social enterprises might tap.

As suggested in Figure 2, the amount of venture capital invested in Australia has expanded quite rapidly in recent years notwithstanding a slump in the first three-quarters of 2002. According to ABS estimates, at June 2001, venture capital managers had raised \$5.7 billion in total of which \$3.7 billion had been invested.

¹¹ Industry Commission (1991), p213.

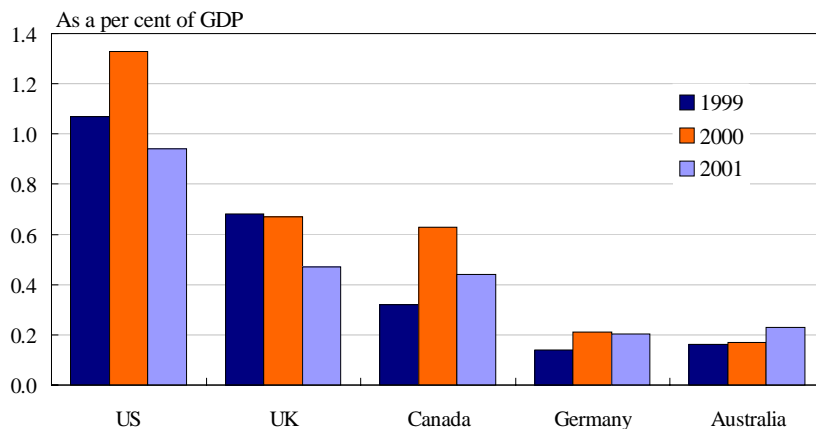
Figure 2
Venture Capital Investments



Source: Australian Venture Capital Journal, March 2003

At the same time, venture capital represents a small part of overall sources of finance for small business, both compared with debt or personal funds or with overseas countries. This is illustrated in Figure 3.

Figure 3
Venture Capital Investment



Source: RBA (2002b)

‘Venture capital’ is often a misnomer with much of it involving finance for the expansion of well-established business or management buy-outs of existing operations. However, the industry in Australia is maturing and it does seem to be close to contributing usefully to initiatives such as social enterprises.¹² An interesting success

¹² For example, Social Ventures Australia has been established to provide three services, namely a mentor network, a learning and development program and venture capital. Given the novelty of the ideas, SVA is

story is Indigenous Business Australia which is a fund with \$72.6 million in equity and generated an operating profit of \$3.9 million in 2000-01 and \$5.6 million in 2001-02.¹³ And this through investing in what some in traditional areas of the finance industry might view as very risky projects in remote Australia.

3.4 Some implications for policy

Financial institutions have the finance, infrastructure and networks needed for the development of any comprehensive scheme to improve the access to capital by economically disadvantaged communities. At the same time, the above discussion highlights that such a scheme needs to recognise:

- support will be required to get enterprises ‘finance-ready’;
- in particular, financial institutions currently have limited skills and resources in-house to screen and monitor the types of projects that are envisaged including social enterprises. Accordingly, public sector involvement may be needed at the early stages of any project. But over time, the policy response should encourage banks to build suitable in-house skills and knowledge;
- where available, both the bank and the borrower will find it attractive to make use of suitable security; and
- private equity may also be a useful complement to debt for some projects.

4. The Evidence on Business Failure

The likely extent of commercial success from financing particular ventures will be critical in the design of a new scheme. There appears to be a common view that even well run small businesses with a potentially attractive business model have a high failure rate. Reports in the press, for example, cite figures of up to 80 per cent of small businesses failing within the first few years of their operations.¹⁴

This paints too gloomy a picture. Bickerdyke *et al* (2000), a team of researchers at the Productivity Commission, have interrogated various sources of ABS and other data and have arrived at a quite different picture. The ABS data have limitations. For example, they relate to employing businesses only and very new businesses tend to be

targeting businesses with a track record and will not favour very small projects. See www.socialventures.com.au

¹³ See Australian Venture Capital Journal 2003, p 24.

¹⁴ See examples cited by Bickerdyke *et al* (2000), p 24.

under-represented in the sample. Nonetheless, the study provides by far the richest picture of business turnover available and the major findings are summarised in Figure 4.

The distinction between business exits and business failures is important. Bickedyke *et al* calculate that around 7½ per cent of businesses exit each year (or around a third within five years). Within this figure:

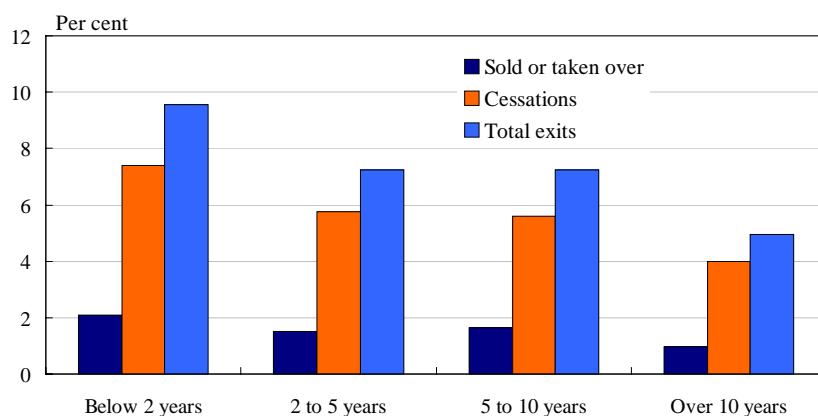
- 1½ per cent exit through a change of ownership (eg a takeover);
- 3½ per cent are solvent but exit for reasons other than the financial situation of the business (eg retirement or death of the owner);
- 2 per cent are solvent but are generating insufficient returns; and
- just ½ per cent represent bankruptcies and liquidations.

Bickerdyke *et al* provide a range of other evidence that is relevant to the current proposal:

- the ownership structure of businesses did not have a major bearing on exit rates;
- smaller businesses tended to have higher exits rates than larger businesses (ie exit rates for businesses with less than 20 employees were close to 8 per cent while those for larger businesses were around 5½ per cent); and
- exit rates declined with the age of the business.

Figure 4

Exit Rates by Age of Business*



Source: Bickerdyke *et al* (2000)

* Data refer to average of 1994-95 and 1995-96

From the perspective of a financier, the greatest concern will be the proportion of business forced to exit because they become insolvent. The ½ per cent figure cited above does appear to *understate* the overall default rates for small business for various reasons

associated with the surveys. In fact, we understand that the major trading banks tend to use default rates in the range of 2 to 5 per cent for their internal modelling, a level that is still quite manageable.

The essential message for the current proposal is that default rates for small business overall are relatively low despite the perception that the lending involved is very risky. The processes and incentives in place for both the borrower and lender are such that suitable finance is flowing to much of the sector. In addition, there is the potential to judiciously tweak the current arrangements to facilitate finance for slightly different activities as advocated in this paper.

**PART B: FINANCING FOR DISADVANTAGED REGIONS:
A SUGGESTED SCHEME**

5. An Integrated Programme

It is critical that the three parties involved, namely the enterprise, government and financial institutions, all contribute financially to the project. For the *enterprise* the case for having some involvement is to minimise both “adverse selection” and “moral hazard”.

In the absence of some finance from the enterprise itself, adverse selection takes the form of those willing to participate being those least likely to succeed, since it is likely they have had difficulty finding assistance otherwise. This prospect is reduced because the enterprise is demonstrating that it is prepared to face some financial losses with respect to the project.

Moral hazard is likely to be more important and takes the form of there being lower incentives to make the enterprise succeed when there are low or zero costs from failure. That is, if the government simply offered a grant to a project so that there was no need for the enterprise to put some of its own resources in jeopardy, there would be less incentive for the enterprise to succeed.

Having support from *the public sector* is justified because of the presumed social benefits of the project and/or market failure in the financial system. This does not necessarily mean that there will be large subsidies, because the form of the collection of this part of the debt – that is, depending on the future profits of the enterprise – in itself constitutes a benefit for borrowers that can only be provided by the public sector.

The active involvement of the *banking sector* will be particularly important. It has the infrastructure in place to raise the capital, screen applicants and monitor performance. It is not feasible to try to replicate those attributes with an entirely new structure.

At the same time, only limited finance is finding its way to community and other projects of concern here. The banks are not attuned to the types of issues that arise and the cost of building the necessary skills and systems could make such lending prohibitive. Furthermore, the experience with the CDB does not provide much encouragement that banks, unaided, would move far down such a path.

One possible option would be to introduce broader social objectives into banks’ licence conditions. In effect, this is the case in the United States where banks are

required to meet targets associated with particular groups in the community. In recent years, corporate Australia – and the major banks in particular – have increasingly recognised that being actively involved in addressing social objectives can make good business sense. Against this background, there is the opportunity to develop schemes that build on the banks’ existing operations with various government programs.

The above discussion highlights the desirability of a program that contains the following three characteristics:

- sufficient **flexibility** to ensure an ability to support local initiatives that may come in the form of quite different ownership structures. In particular, the nature and extent of collateral will vary as will responsibility or accountability for the project’s success. The extent and mode of financial support will vary across projects;
- an **alignment of incentives** with, for example, sufficient equity or other forms of commitment from the borrower to foster the project’s commercial viability; and
- the support from government to get projects to a stage where they are **finance-ready**.

Any such project will need initial vetting and then close monitoring throughout. It is unrealistic to assume that government could play a useful ongoing monitoring role; rather, it is best placed to help projects get off the ground, and do so in a way to maximise their chance of ultimate success.

From the government’s point of a view, a two-stage approach is envisaged with a separate government agency involved at each stage.

Stage 1 – Pre-financing

The proposal would initially be vetted under a new government scheme, the *Social Enterprise Initiative* (SEI). The SEI would be managed by a dedicated unit, say the Office of the SEI.

Under the SEI, proposals would be assessed and feedback and support would be provided. Where additional work is deemed necessary to develop proposals to a finance-ready stage, the SEI would be able to:

- tap into the range of programs already in existence (including those under the AusIndustry umbrella); and
- provide grant money to *partially* fund the refinement of proposals eg for the production of a detailed business plan. The level of such grants would vary, but could range between say \$5,000 and \$50,000.

In some instances, the feedback from the SEI may take the form of identifying gaps in management or other skills that the enterprise will need to satisfy a financier of its likely commercial viability.

Suitable proposals would then be referred for consideration for financing. The SEI performs a valuable part of this process by reducing the screening costs that past experience suggests would seriously restrict the extent of private funding that would be forthcoming.

Stage 2 – Financing

There are three parties to the financing: the enterprise, the government and the relevant financial institution. In most projects being considered, the additional private finance being sought will take the form of debt and the financial institution will be a bank. However, private equity injections will be appropriate for some proposals and it is important that the vetting process does keep this option open. Indeed, the involvement of, say, a venture capital fund may bring more management skills to the table than would a bank.

The Government's role in assisting the financing would be the responsibility of the Office of Social Enterprise Finances (SEF). This would be a quite separate agency to the Office of the SEI in order to ensure that financing decisions are made on an arms-length basis from the development of any proposal.¹⁵

Public financial support will take the form of profit related loans. Having support from the public sector is justified because of the social benefits of the project and/or market failure in the financial system. This support takes two forms, namely any subsidy embedded in the loan itself and the fact that the form of the collection of this part of the debt – that is, depending on the future profits of the enterprise – in itself constitutes a benefit for borrowers that can only be provided by the public sector. These issues are explored in the following sections.

¹⁵ That is, the two stages will assist in the governance aspects of the public sector's involvement.

As outlined above, the possible projects will inevitably represent a spectrum with some having a stronger community element while others will have a stronger private element:

- a project with minimal social benefits may still be attractive since (i) funds would still be flowing into a depressed area; (ii) the individual(s) involved would be required to provide greater collateral making monitoring and the involvement of the banks easier; and (iii) the overall scheme could more readily reach a scale that is attractive to the continuing involvement of banks. The contribution from public funds would also be less for individual projects where the social benefits are low.
- the benefits to be derived from broader community-based projects would be larger, but some inherent difficulties would have to be overcome. In particular, it may be more difficult to get real ownership from the principals involved (and thereby minimise moral hazard problems). For example, the initial contributions may have come from community fund-raising with the drivers of the project being motivated by doing “good works” rather than a stronger commercial imperative. In such circumstances, suitable buy-in by those involved can still be achieved, but the design, selection and monitoring elements of the scheme become critical.

Accordingly, the Office of the SEF will determine the appropriate level of profit-contingent loans depending upon the expected community benefits from the project and the extent of the buy-in from those involved in the enterprise. There could also be the option for the Office of the SEF to provide some direct grant for particularly desirable projects if this were deemed necessary to make the project a viable commercial proposition. Many different possibilities are available with respect to the examples considered in Section 7.

After determining the extent of public support, the Office of SEF would coordinate with the relevant financial institution – eg bank or venture capital fund – to bring the full package of financing together. The examples in the following Section 7 provide illustrations of the appropriate balance between each element.

As an aside, the above stressed the need for the close involvement of a bank (or other financial institution) to ensure that the projects operate as commercially as possible.

However, at the initial stages, the banks may be reluctant to be involved given the limited size of the program and the lack of a track record:

- accordingly, it might be necessary in the early stages for the program to operate as a pilot with banks being paid a fee for vetting/monitoring services.

As the program becomes established, the scheme could in principle be open to any bank. Instead, we recommend that banks tender to assume the role of principal debt financier for the scheme. The successful bid would be based more on the nature of the commitment the bank would bring to the task rather than any fee. The attractions of having a single bank involved in the early part of the scheme include:

- benefits for the successful bank in terms of its corporate image and, over time, having a head start in establishing a potentially profitable new line of business; and
- for the Government, having greater confidence that there would be an ongoing commitment to the success of the scheme from a large financial player.

6. The Background to the Collection Process: Income Related Loans

The summary provided in the Introduction for the financing of social enterprise projects involves the use of a government approach to financing known as “income related loans”. The background to this aspect of the proposal is now explained.

The basic IRL idea is that agents provided with government assistance in periods of economic need should be expected to repay some part of this financial help when their future economic situation is more propitious. This means that a social enterprise receiving public funds as part of the SEP would treat a proportion of the financial assistance as a loan to be repaid when future income – represented by profits – allow this to be done without compromising the viability of the initiative. The conceptual basis, and some experience, of IRL are now explained.

The first national application of an IRL was the Higher Education Contribution Scheme adopted in 1989, in which Australian university students are able to pay tuition charges depending on their future incomes.¹⁶ IRL for the higher education student tuition and/or income support have been, or will soon be, adopted in New Zealand (1991), Chile (1994), South Africa (1996), the UK (to be implemented in 2005) and Thailand (to be

¹⁶ While in practical terms the scheme was an Australian innovation, the notion has been in the economics literature since at least Friedman promoted a variation of it in 1955 (Friedman, 1955).

implemented in 2006). The Australian experience in particular means that we now know quite a lot about the effects and administration of IRL.

The basic idea behind HECS is as follows. In the presence of a charge on students, those without access to finance would not be able to attend university since banks in general will not lend for human capital investments. The reason is that graduates' future labour market outcomes are uncertain, and in the event of default a bank would have no collateral to sell (which is not the case for example with respect to a housing loan). There are many different risks associated with student financing, and these are discussed fully in Chapman (2003).

These risks mean that some form of government intervention is required in the financing of human capital investments. Such intervention can take the form of the guarantee of the payment of bank loans in the event of default, the governments paying some of the interest on a bank loan, and/or the provision of means-tested scholarships that waive the obligation for qualifying students to pay tuition charges. Many countries currently use varieties of these approaches, most often involving partnerships between commercial banks and governments (for example, in the US and Canada).

For a variety of reasons explained in Barr (2001) and Chapman (1997), IRL are preferable to other approaches to financing human capital investments. In this context, a critical factor relevant to their application in the financing of social enterprise projects is that, unlike with respect to bank loans, IRL take away the default risks for borrowers. That is, if future economic circumstances turn out to be poor in a particular period, a well-designed IRL would require no or only minimal payments. This has the fundamental advantage of allowing credit risks for borrowers to be avoided.

That is, IRLs offer insurance against the possibility of future hardship and, in the extreme, protection against default. Other types of loans do not offer this type of security.

There has by now been a considerable amount of research on HECS. With respect to the financing of social enterprise projects two particular facts are relevant. The first is that the scheme has had no adverse consequences for the access to university of relatively poor prospective students, whose numbers increased by about 40 per cent in the 1988-99 period (Chapman and Ryan, forthcoming). An interpretation of this is that, not only did HECS in reality offer default-protection for students, it was also apparently seen to do so.

The other fact is that the collection of HECS revenue, through the Australian Tax Office, has turned out to be very efficient. In administration terms it costs less than 4 per cent of the \$1 billion revenue now raised annually. Thus while before its introduction in 1988 Australian tax authorities warned against the alleged major administrative complexities, this has turned out not to be the case.¹⁷

Several other possible applications of the basic principle of IRL have been developed over recent years. The following examples are of interest:

- (i) For the financing of drought relief (Botterill and Chapman, 2004);
- (ii) With respect to student income support (Chapman, 1992);
- (iii) For the collection of low level criminal fines (Chapman, Freiberg, Quiggin and Tait, 2004);
- (iv) To recover a portion of taxpayer's subsidies from subsidised elite athletes (Denniss and Hamilton, 2003);
- (v) For the provision of housing credits for low-income individuals (Gans and King, 2003); and
- (vi) With respect to the collection of fines associated with collusion and insider trading (Chapman and Denniss, 2003).

In addition, there is the potential for a host of additional applications, including involving R&D expenditure and other government assistance to industry.

What HECS and the above potential IRL applications have in common are the following. One, generally they involve the government providing a default-protected loan mechanism for the particular beneficiaries, usually in a situation in which the commercial banks would be reluctant to take on the associated risks. Two, they allow the potential for the recovery of a proportion of taxpayer subsidies to specific activities, but only in the situation in which members of the targeted group are experiencing propitious later circumstances. That is, IRL have the potential to both improve the functioning of markets and to promote equity.¹⁸

The application of an IRL for social enterprise activities fits neatly into the above contexts, and has the following advantages:

¹⁷ For a discussion of the implementation debate with the Australian Taxation Office, see Edwards (2000).

¹⁸ These notions fit comfortably with recent innovations in policy thought promoted by both Moss (2002) and Shiller (2003).

- (i) The approach could act to improve the functioning of loan markets where social enterprise activities are below what a government might consider to be optimal;
- (ii) Because some part of taxpayers' subsidies would be recovered when the enterprise is succeeding commercially, there is an important equity dimension;
- (iii) Not only is it fair that average taxpayers don't eventually foot the bill for all subsidies to successful enterprises, the fact that there are returns to the public sector should also be seen to be desirable because the associated potential to reduce Commonwealth budgetary pressures. The repayments thus allow the financing of more social enterprise projects than could be forthcoming if the scheme was solely grant financed (or lower taxes, or higher provision of alternative government services); and
- (iv) IRLs essentially provide a form of revenue (or profit) smoothing, and thus diminish financial pressures on enterprises at the time in which this is most needed.

7. Illustrative Detailed Examples of Profit-related Financing for Disadvantaged Communities

The proposal advocated in this paper is aimed at providing better access to finance for a wide range of commercial and not-for-profit operations. Projects will vary considerably based on scale, the extent to which broader public benefits accrue, the nature of the commercial activity and the sophistication of the management team.

As such, for any scheme to be effective it will have to be flexible enough to respond to the specific circumstances. The incentives faced by each of the three stakeholders – that is, the proponents of the project, the financial institution and the government – will have to be suitably calibrated. Accordingly, the proposed Office of the SEI and, especially, the Office of the SEF¹⁹ will require a degree of flexibility in setting key parameters for each individual project.

This flexibility, unfortunately, introduces a degree of complexity in the detailed arrangements for the scheme. Some of this complexity could have been avoided by designing a more rigid scheme; however, we judged that it is important for the incentives

¹⁹ See Section 5 for a description of these Offices.

and obligations be introduced into each project in a way that is apposite for the specific circumstances.

What this does mean, however, is that the explanation of how the scheme will apply in practice becomes multi-faceted. The following discussion is designed to illustrate how the scheme would work in practice and provide a sense of how, over time, a significant proportion of funds outlaid can be expected to be returned to the taxpayer. Throughout it is important to recognise the basic motivation and structure that was outlined in Section 5 and runs through all of the examples now considered.

The discussion considers four generic types of projects which we will term ‘Cases’. In turn, within each generic Case, some projects will be (financially) successful, some will struggle but stay afloat, while some will fail. The worked examples assume a mix of success rates within each Case.

The different Cases are characterised by whether:

- they are for-profit or not-for-profit ventures; and
- the degree of access they may have to assets that can be used as security for debt finance.

In particular, the four generic Cases are:

- **Case (A)** – Profit-making ventures that require a fair amount of physical capital (eg building or equipment). These assets can be used as security for bank debt.
- **Case (B)** – Profit-making ventures that require less physical capital, but where a longer period of cash flow support may be needed for the projects to become viable. (For example, customer relationships will take time to establish for companies in the service sector.)
- **Case (C)** – Not-for-profit businesses with high turnover and low margins on goods sold (eg retail businesses).
- **Case (D)** – Not-for-profit business with higher margins on goods sold but higher labour costs (eg companies providing business services).

The repayment conditions are critical to an understanding of how the model works. The Office of the SEF will set these conditions at the outset for each project. In all cases, the enterprise will enter into a conventional contract with the bank, agreeing to

meet a stream of (interest and principal) repayments along the lines as would apply in any commercial relationship.

In contrast, the repayment conditions for the funds from the government sector will be quite different because they take the form of an income related loan and will vary according to the nature of the venture involve. In particular, the extent to which the projects can be expected to deliver commercial returns will have a critical bearing on which income base is used as the basis for repayment for the income contingent loan.

Consider first those projects expected to make a commercial rate of return. Projects falling under either Case (A) or Case (B) are aimed to be profit-making ventures where the element of public financing is made contingent on future profits. Where feasible, having payments based on **profits** has the desirable feature of minimising any distortionary effects on decision-making. Consequently, it is proposed that repayments of the government loan be based on earnings after interest but before tax.²⁰ (They are most appropriately viewed as being an income contingent interest payment rather than a tax.)

On the other hand, there will also be situations where ventures are undertaken either by not-for profit organisations or where there is a strong community element involved and future profits are expected to be quite low.²¹ Thus, for Cases (C) and (D), it is proposed that financing be contingent on **operating margins** (ie as per the base for the GST).

Note that in each case, repayments are based on information that is already collected. In administrative terms this would seem to be straightforward. When the government loan finances are provided, the amount would be registered as a debt with the ABN of the enterprise, and collected in the future in much the same way that HECS operates, although with profits or operating margins in this case, not individual incomes, forming the basis of the collection.²²

These examples only involve debt financing (including profit-contingent debt from the Government). Section 5 also canvassed the option of providing equity finance

²⁰ That is, for tax purposes, the repayments are akin to interest payments rather than a top up to corporate taxes.

²¹ Indeed, the primary motivations for many projects may not be profit-related and prudent financing of the project could not be realistically based on an expected stream of profits.

²² Botterill and Chapman (forthcoming) suggest and explain a similar arrangement for farmers to repay some proportion of drought relief.

from, for example, a pooled development fund. The analysis that follows can be readily extended to such a situation.

In each Case, there will be numerous parameters that need to be taken into account for the Office of the SEF to determine the precise arrangements to apply to each project. Also, the likelihood of success – both in terms of the project evolving into a long-term viable entity and in what financial returns the Government can anticipate from its initial outlay – will vary.

For ease of exposition, Case (A) is described in some detail with a discussion of the sensitivity of the results to the main parameters involved. This sensitivity analysis carries over to the other Cases and thus the discussion of these is much briefer.

Finally, it must be stressed that these worked illustrations are just examples. The precise parameters will be subject to the experience with pilot programmes as well as detailed negotiations with the various stakeholders (including financial institutions). And when operational, will be subject to fine-tuning by the Office of the SEF to suit the needs of the specific project.

7.1 Case (A): A commercial venture with a need for physical capital

Description of the type of business

The types of business envisaged in the first set are for-profit ventures that require physical capital such as buildings or assets that are able to be leased. For example, this may include a retail business or a specialist business in a trade that calls for the use of motor vehicles and perhaps specialist equipment. In either case, there will be security to support at least some of the financing.

In every example that follows, it is assumed that \$100,000 is required. This amount can obviously be scaled to reflect the reality of particular projects under the scheme.

The funds come from three sources:

- A **financial institution** is assumed to provide \$50,000 line of credit up front. The loan is secured against initially a book value of \$60,000 of physical assets. Given that this credit will attract interest, and the Government is paid out of after-interest profits, the risk for the financial institution is low even though the project may be deemed to be high risk. Accordingly, a real interest rate of 5½ per cent is assumed. (Any surplus cash is assumed to attract a similar interest rate in an offset account.)

These parameters are designed as a balance between making the proposition sufficiently attractive for the financial institution to be involved and to leave it with enough risk so that it continues to devote appropriate resources to monitoring and managing the project and its position.²³ The parameters would be refined with greater experience in lending in such novel circumstances.

- The **government** is assumed to provide \$30,000 in the form of a contingent debt labelled ‘Social Enterprise Contingent Debt’ or SECD.²⁴ While the government is happy to seed the project, it may be desirable for it to have an ability to scrutinise both the progress of the project and the commitment of the financial institution in the first few years. Accordingly, the \$30,000 is assumed to be paid in three equal instalments.

The real interest rate to apply on the SECD is assumed to be 8 per cent for the first 5 years of the project. Thereafter, it would be set at 4 per cent, which is roughly the government’s cost of funds. Repayments are contingent on the operation being successful. They are assumed to be 25 per cent of earnings (after interest but before tax) as long as such earnings are positive.²⁵

- The **proponents** of the project are assumed to contribute \$20,000 of capital up front. An equity contribution will help to align the incentive structure, although the precise level of such a contribution would be determined on a case by case basis and will vary depending upon the extent of public benefits.

For ease of exposition, it is assumed that the project loses money in the first year, breaks even in the second year and then makes a constant return on the initial capital thereafter (unless it goes bankrupt). Of course, successful projects will grow over time whereas others will struggle. All calculations have been carried out in today’s dollars.

²³ For example, the financial institution is likely to receive less than its \$50,000 exposure from the sale of the physical assets in a fire-sale situation.

²⁴ As outlined in the text, the Government may also fund some of the initial feasibility work through the Office of the SEI. Such funding is assumed to be in the form of grants and is not included in the worked examples.

²⁵ While such a payment may appear to be akin to a tax, it is best viewed as an agreed arrangement to repay debt according to the profitability of the operation. Nonetheless, the repayment parameter selected will have to recognise possible disincentive effects if it is too high. A repayment rate of 25 per cent from before-tax earnings means that the enterprise is able to retain 48 cents in the dollar of earnings after interest while the government loan is being repaid. (In practice, the enterprise in the early years is likely to have tax losses carried forward and the effective tax rate – and any resultant disincentive effects – will be lower and the amount retained higher than the 48 cents in the dollar cited here.)

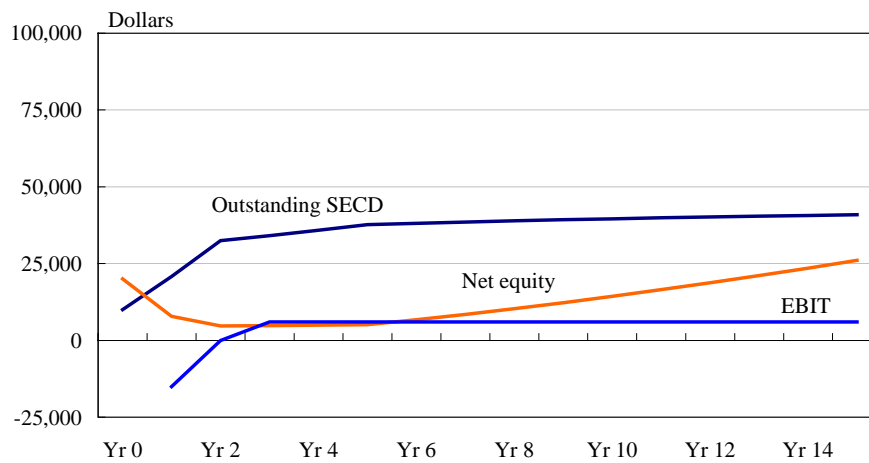
To illustrate the profile of the development of the projects and the repayment streams from the Government's initial outlay, the projects are assumed to fall into four 'categories':

- **Category 1 – 'survival'**: these projects are assumed to struggle to stay afloat, generating an assumed rate of return on capital of 6 per cent, that is, just above the cost of bank finance and above the interest rate applied to SECD debt after the first five years.
- **Category 2 – 'solid growth'**: these projects prosper and would comfortably service debt and meet various benchmarks. This situation is characterised in what follows as generating returns on a fixed initial capital of 12 per cent. Alternatively, similar results in terms of the project's ability to service debt would be achieved if a somewhat lower rate of return were assumed but with retained earnings feeding into a greater expansion in the project.
- **Category 3 – 'success'**: these are the real (financial) success stories with an assumed rate of return on capital of 20 per cent. (Again, the results would be similar if there were a somewhat lower return on capital but with retained earnings being used to expand the project.)
- **Category 4 – 'failure'**: those projects that are wound up within a few years without delivering any returns to the public coffers;

Key financial variables for the first three of these situations are depicted in the following charts:

- Earnings before interest and tax simply reflects the assumed losses in the first few years followed by the 6 per cent return on \$100,000 of initial capital.
- Net equity starts at \$20,000, but is eroded in the initial years by the assumed losses plus the servicing costs on bank debt. It steadily recovers as profits are able to finance bank debt, the SECD and, after initial tax losses are offset, corporate tax. Note that net equity includes both tax losses and the (contingent) liability to the Government, even though both these items will be uncertain in the initial years.
- The outstanding SECD increases in the initial years as the Government's contributions are outlaid. The extent to which it is reduced in subsequent years reflects the extent to which payments exceed the assumed rate on this debt.

Case (A) - 'Survival': 6% return on capital

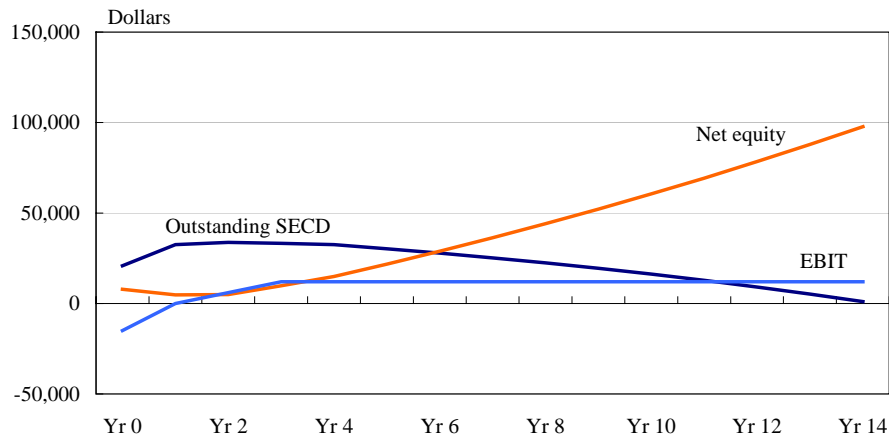


Note that, in the 'Survival' category of businesses, the outstanding SECD liability is only reduced very gradually since profits are low. A modification in some of the key parameters could bring forward the repayment stream. In addition, the project owners may wish to do so in any case.²⁶ However, given this business is assumed to be operating near the edge, it is inevitable that the outstanding liability to the Government will persist for a considerable period.

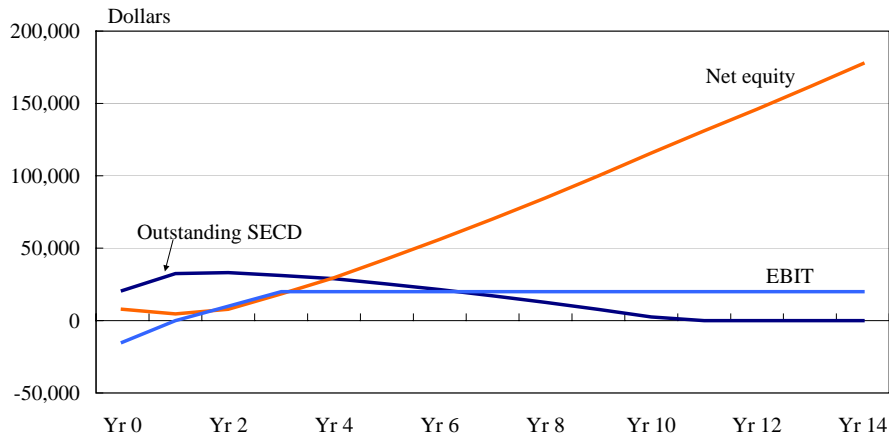
The other two groups of businesses are assumed to be more profitable and repayment occurs earlier, namely after around a decade of profitability for businesses generating 12 per cent returns and after 4 years of profits for businesses generating 20 per cent.

²⁶ In particular, the design of the system provides a modest tax incentive for early repayment given that any repayment of the debt – as with any interest charge – is tax deductible.

Case (A) - 12% return on capital



Case (A) - 20% return on capital



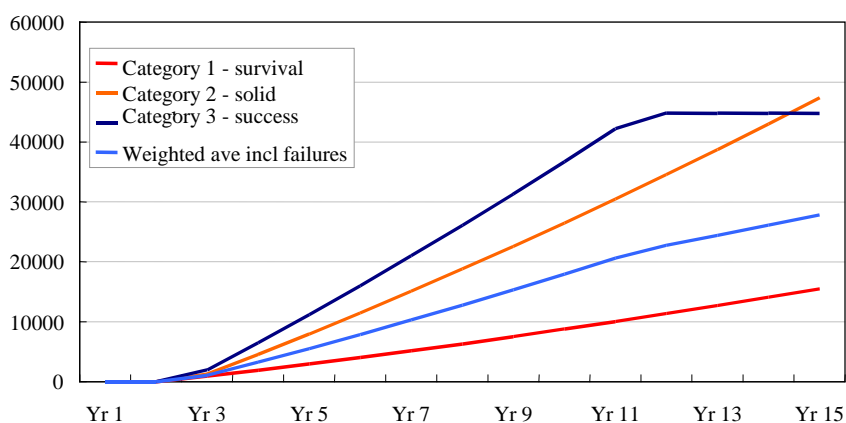
Obviously, the extent to which the entire programme will be self-financing will depend on the profile of projects that are supported. Effective selection and support from the Offices of the SEI and SEF will be critical as will the continuing monitoring by the financial institution and, in many instances, the local community.

Inevitably some businesses will not succeed. The evidence cited earlier concerning default rates for lending to SMEs suggests that this ratio may be relatively low, although the novelty of many of the projects to be supported will make the exercise more risky from a narrow financial perspective.

The following chart illustrates the overall impact of the returns to the public purse assuming 20 per cent of businesses fail, 30 per cent 'survive' (by delivering average

returns of 6 per cent), 30 per cent provide ‘solid’ 12 per cent returns and 20 per cent are financial ‘success’ stories generating 20 per cent returns.

Profile of SECD Repayments : Case (A)



The chart indicates that the initial \$30,000 outlay would almost be recovered after 15 years.²⁷

7.2 Case (B): A Commercial Venture with a Need for Cash Flow Support

The types of business envisaged in the second set are for-profit ventures that require longer gestation periods to become financially viable, as well as a need for less physical capital. Many of the businesses being envisaged would be in the services sector where reputation, brand and an innovative product are potentially cornerstones for the business.

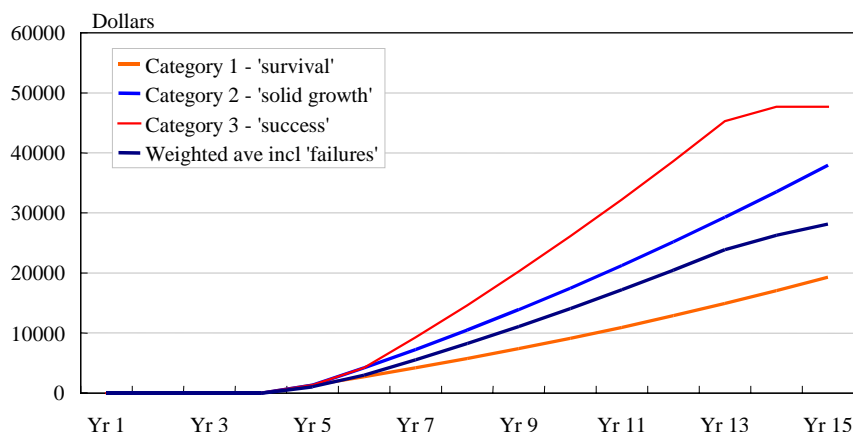
Compared with Case (A), there would be less security available on which to support bank credit. Accordingly, the main changes when compared with Case (A) are:

- a longer period before the business becomes profitable. In the following example, break even is achieved in the fourth year and consistent profits thereafter; and
- the requirement that the project proponents inject a larger amount of equity. In particular, it is assumed that the typical project would require \$30,000 credit from a financial institution, a \$30,000 contingent loan from the Government and \$40,000 of equity from the proponents.

²⁷ Assuming a real discount rate of 4 per cent, the NPV of the repayments is around \$21,000 after 15 years.

The remaining parameters are the same as in Case (A). The results are qualitatively similar as illustrated in the following summary chart.

Profile of SECD Repayments: Case (B)



7.3 Case (C): A Not-for-profit Business with high Turnover²⁸

The final two cases relate to either not-for-profit businesses or businesses that are judged to have a strong community value but with little chance of generating significant profits. Accordingly, repayments cannot be based on a direct measure of profits. Instead, it is proposed that they be based on margins as is done with the GST base.

The challenged that needs to be finessed is to design a system that can cope with both:

- businesses with relatively low margins on a high turnover of goods such as in the case of businesses in the wholesale or retail industries (Case (C)); and
- businesses with minimal inputs of goods but where the costs largely relate to labour (Case (D)). Margins (that is, the difference between cost of goods bought and sold) will be quite large.

In each of these Cases, the parameters have been calibrated for the different extent of financial success to be roughly comparable with the four categories of success used above, namely 'survival', 'solid growth', 'success' and 'failure'.

The major design characteristic that needs to be carefully selected here will be the repayment parameter. This applies to margins, that is, before operating expenses. For high turnover, low margin, businesses such as wholesale operations, an unduly high

²⁸ Note that while we are considering not-for-profit entities, this does not preclude the particular project being profitable and generating an income stream for the rest of the entity.

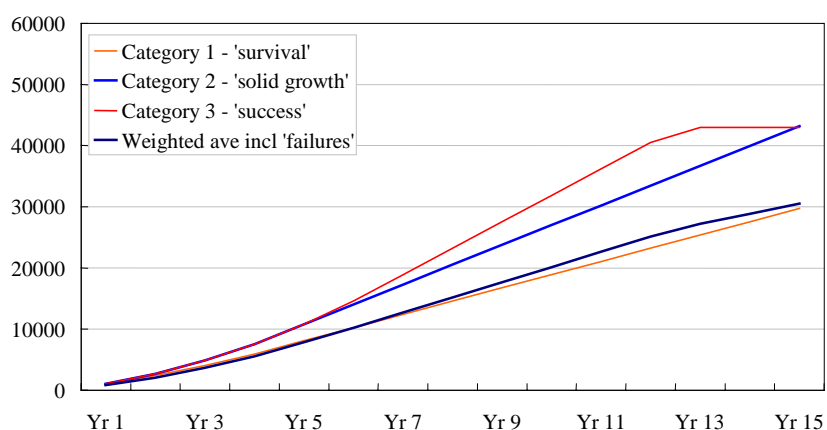
parameter will see the SECD being repaid promptly but at the risk of sending the business into bankruptcy.

In (Case (C)), we have assumed that goods are sold with an average mark-up of 36 per cent. This mark-up is used to pay operating expenses and service bank and SECD debt. We also assume that 3 per cent of the margins is used to repay SECD liabilities.²⁹

Two features of the results are important for our discussions:

- the SECD repayment profile is not as sensitive to fluctuations in the underlying profitability of the project (that is, in comparison with the earlier Cases where repayments were directly based on profits). Thus, in the

Profile of SECD Repayments: Case (C)



following chart, the trajectory of the repayments for the different categories of projects are more tightly bunched than for Cases (A) and (B); and

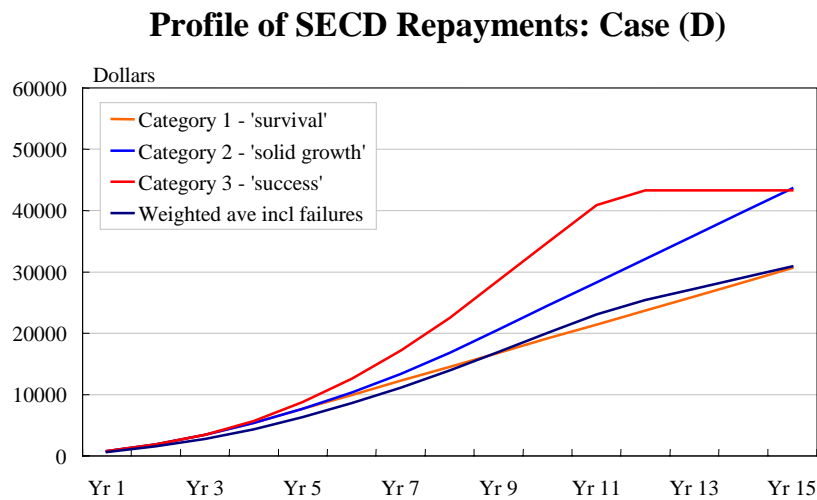
- related to this, the fate of any project in the 'survival' range will be sensitive to small fluctuations in some of the key parameters including the repayment rate.³⁰ It then becomes crucial that the arrangements agreed at the outset with the Office of the SEF are carefully calibrated.

²⁹ Note that 3 per cent of operating margins in Case (C) yields a similar repayment stream as 25 per cent of earning (after income but before tax) in Case (A).

³⁰ To some extent, this sensitivity reflects the mechanical nature of the experiments conducted here. If market conditions allow the project some flexibility in adjusting margins and/or scale, the project will be able to be more robust.

7.4 Case (D): A Not-for-profit Business with Low Turnover and Higher Operating Expenses

The final case will typically involve a service business with significant labour costs within its operating expenses. Given that operating margins (ie the gap between costs of goods and services bought and sold) is larger here than in Case (C), the repayment rate will need to be corresponding lower. In the following chart, a repayment rate of 1.8 per cent of the operating margin is assumed.



The above examples illustrate how a few key parameters can be adjusted to take into account the precise nature of the project involved. In each of the examples, the Government can provide critical support to get otherwise what can be difficult projects off the ground. At the same time, the incentives that the project will face ensure that financial viability remains a key objective and the impact on the public purse over time is minimised.

8. Conclusions

Fresh approaches are needed to channel increased financial resources in economically disadvantaged sections of the community. Success stories are accumulating throughout the country with, for example, the rise of some promising social enterprises. But for such initiatives to reach a scale where substantial benefits accrue throughout the communities, the active involvement of government and financial institutions will be needed alongside local enterprises.

This paper advocates a scheme based on profit related loans. The scheme provides a mechanism whereby both banks and government contribute to social and other private enterprises, but where the drive and responsibility for success of individual projects rests squarely with the enterprise. Taxpayers will get a return from their investment in successful enterprises.

Because of the originality of the scheme, it is critical that there is some experimentation at the outset, perhaps through the introduction of different pilot programs. With flexibility and the obvious potential for learning by doing, the basis for a firmer public sector commitment, and its nature, should be forthcoming.

Moreover, even as the scheme develops, the lending advocated here will entail risk. New businesses will be created and a number of them will fail. It is important not to shy away from such experimentation and natural selection. Indeed, as the OECD has emphasised, the ability to create new businesses *and* to replace poorly performing ones can be a major determinant of an economy's overall economic performance.³¹ These ideas are arguably more apt when applied to economically disadvantaged areas where the greater vitality has the potential to bring both economic and social benefits.

³¹ See Bickerdyke *et al* (2000) for a discussion of this point.

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Appendix

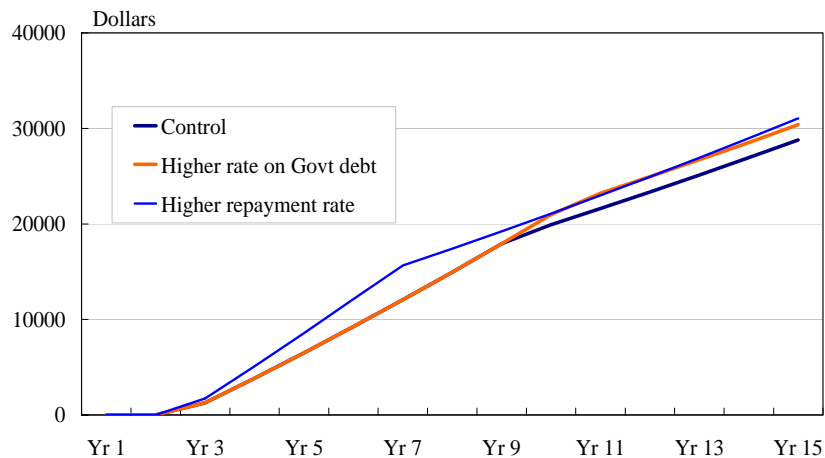
Sensitivity Analysis of Case (A)

Section 7 presented key results for the worked examples of various potential projects. This Appendix briefly explores how sensitive those results are to changes in key parameters. Only Case (A) is examined here, but the general conclusions apply to the other types of businesses that are discussed in the text.

The first chart illustrates the results of tinkering with the key parameters on the contingent liabilities to the Government. It examines (i) the impact of raising the repayment rate from 25 per cent to 50 per cent; and (ii) increasing the interest rate on that debt to 10 per cent for the first 5 years and 8 per cent thereafter.

Appendix Figure 1

Sensitivity analysis (1)

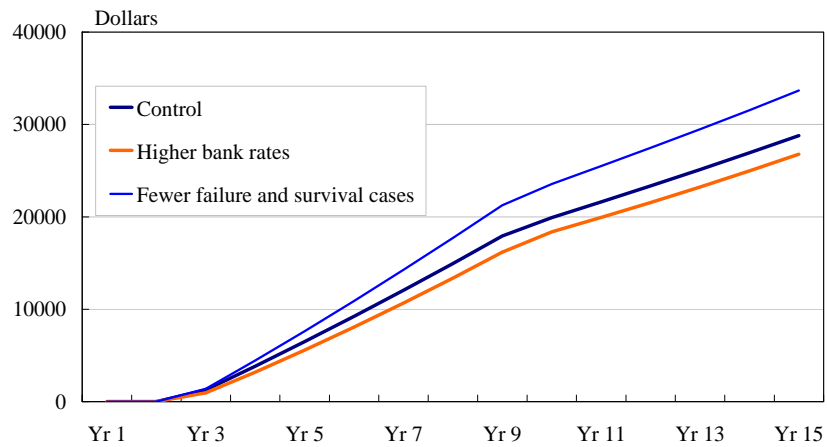


The results are intuitively reasonable. The higher repayment rate does bring forward the income stream while the largest impact of a higher interest rate is to increase the outstanding amount of debt. The shift in parameters in each case was considered to be quite sizeable, but the overall impact was not very large.

The next chart illustrates the impact of (i) an increase in the rate of interest applied to bank credit; and (ii) a reduction in the proportion of ‘failures’ (from 20 to 15 per cent) and ‘survival’ cases (from 30 to 20 per cent).

Appendix Figure 2

Sensitivity analysis (2)



Again, the results are largely as expected. Perhaps not surprisingly, the most useful change from the point of view of the programme becoming self-financing is to limit the number of ‘failures’ and ‘survival’ cases.