Inquiry into Access of Small Business to Finance

Reference

http://www.aph.gov.au/senate/committee/economics_ctte/small_business_10/index.htm

The current structure of the financial system means that large business and governments have easier and cheaper access to finance than small business. Finance for small business is costly and difficult to obtain.

Finance costs can be substantially reduced by reducing the cost of credit and making it more accessible to all businesses both big and small. The cost of credit can divided into two parts. There is the risk that the credit will be dishonoured and there is the cost of money itself. It is this second cost that this submission addresses.

Most Australian dollars are created as a result of commercial banks making interest bearing loans secured against existing assets. The Reserve Bank also makes interest bearing loans to banks but this is a small percentage of the loans, and hence money, on issue. Because money is created through interest bearing loans this means that there is a fixed cost of providing money that is in addition to the costs associated with the use of the money. The Reserve Bank also creates notes and coins. These attract no interest. Because notes and coins attract no interest the cost of payments using them is lower than the cost of payments using electronic money. The main cost of physical cash is the cost of handling and moving it and is generally covered by transaction costs. Removing interest from electronic money used as for cash payments will reduce the cost of doing business - particularly for small business. The cost of handling electronic money is miniscule in relation to its value and transaction fees should be very low. The cost of electronic money transactions is made more expensive than it needs to be because many debit transactions incur similar fees to credit transactions and electronic money incurs the cost of carrying money.

The reason the financial system generates money through loans backed by existing assets is to ensure that loans get repaid. That is, if the loan is not repaid then the issuing bank can seize the asset and sell it and so repay the loan.

However, money can be created without monetizing existing assets. We can create interest free loans, or Bank Cash, and ensure that the money gets repaid, or never earns interest, by putting conditions on the use of the money. With modern technology we can ensure that recipients of Bank Cash, automatically comply with the conditions on the use of the Bank Cash.

We can use Bank Cash judiciously to remove the disadvantages of trading with electronic money as though it were credit suffered by small business. Bank Cash however, will not alter the existing financial system which will continue to provide financial services without interruption.

Possible Implementation of Bank Cash

If the money used to exchange value is NEVER loaned then there is NO risk to the money. Because it is not loaned then it earns no interest. We can thus create Bank Cash with the provision that this money only ever moves into other interest free trading accounts.

Bank Cash can take advantage of modern communications and computing technology and is easily set up in Australia. The following outlines one possible way it might be implemented.

Any bank, or all banks, that wish to participate can join the system. Businesses and consumers signup to participate in the system. If we assume the fractional reserve for a bank is 10% then the borrower deposits 10% of the Bank Cash they need. This will purchase for them 100% of Bank Cash. There will be a limit on the amount of Bank Cash that any person or entity can create. Let us assume that it is $5000 for individuals and $100,000 for small business. Bank Cash is the same as ordinary money except it is not allowed to earn interest while on deposit. Governments will lead the way in adopting Bank Cash by agreeing to accept payments for taxes and other fees and charges with Bank Cash and to agree not to lend this Cash.

The limit on the total amount of credit available to any borrower will now be determined by the willingness of other parties to offer credit - not by the availability of money.

Bank Cash can only be used be used for the transfer of value between participating parties. The money cannot be lent nor can it earn interest. Because the loan does not earn interest it is of zero value and cost to the bank and it can be transferred between bank accounts without affecting the books of the bank.

Some businesses will accumulate more Bank Cash than they need for trading with other parties. They can sell this Bank Cash to people who want to trade using this cheaper money. Because a business has to deposit money to get Bank Cash and because there is a limit for each entity in the system it will be attractive for businesses and individuals to purchase excess Bank Cash from other businesses than to create more Bank Cash themselves.

The net effect of this approach will be that money used for trading between participating businesses and individuals will have no interest charges. Credit may have an interest charge but that is a matter between the business offering credit and the business or individuals who have no Bank Cash.

Banks still offer a service of overdrafts and they can assist businesses assess the credit worthiness of other potential borrowers and they can charge transaction fees on the movement of money. Banks no longer have to assess the credit worthiness of each business nor do they take a risk on credit.

Interest free Bank Cash is an alternative to credit and debit cards for individuals and overdrafts for businesses - but there is no reason why Bank Cash cannot be transferred using credit and debit cards.

The system is voluntary and does not need any new legislation. It just needs a bank to start offering the service and for governments to agree to accept Bank Cash for payments of taxes and fees. The reason banks do not offer this service today is that they can obtain higher profits by the interest differential on money created by monetizing existing assets, they can charge high transaction fees disguised as credit charges and, make unnecessary credit charges. It is estimated that reduction in the financial cost of transactions will, each year, save the economy - particularly small business - several billions of dollars.

Equity Investment

Conceptually equity investment is the same as exchange of value but on a longer time scale. Here, instead of goods being traded, ownership of assets is traded. The current financial system creates money through giving credit by exchanging part ownership of existing assets. This works well for existing assets as the ability of the assets to generate income enables the borrower to fund the credit.

However, credit is generally not available to build future assets. This means that to build new assets money has to be obtained from savings or from loans on existing assets. This increases the financial cost to build new assets as the builder of the new asset has to pay the cost of money plus the cost of the risk of the new asset failing to generate income. It means that relatively little money is available for expansion of assets compared to the amount of money available to purchase existing assets because there is no credit mechanism available to fund investment in new productive assets.

The lack of money to build new assets stifles productivity gains because productivity improvements come from investment. The lack of money for investment is particularly acute for small business as they do not have the asset base on which to generate money for investment through the creation of loans. That is, it is much more costly for small business to invest than it is for large business or for governments because small businesses do not have access to assets they can monetize.

The problem of funding new investment can be overcome by the community (government) providing Bank Cash for equity investment in NEW assets through the issuing of special purpose Bank Cash to construct new assets. The Bank Cash must be invested in new assets and it must be repaid from the returns on the new assets. That is, the money purchases ownership or gives equity in the new assets. How much ownership is transferred and the value of that ownership is a matter between the buyer and the seller. Once the equity in the future asset is purchased then the money becomes regular money and can be lent for interest. Repayments of Bank Cash can be made with Bank Cash or interest bearing money.

Administrative issues with this scheme is that there has to be a limit on how much Bank Cash is created, who gets the right to receive Bank Cash for investment purposes, what investment purposes qualify for Bank Cash, and how to ensure the Bank Cash is automatically repaid through the profits on the investments.

This is an area for government policy. The approach can be used to direct investment in areas of community need where private investment through traditional equity markets is not providing the funds needed to build new productive assets. Small business investment is one area where interest free loans (Bank Cash) can be given for new investments and the Federal Government is already doing this through the Department of Innovation, Industry, Science and Research with its commercialisation loans for small business. Unfortunately there is little money available and the administratve overheads in running this program are very high because of the way the program has been implemented - but the principle has been established.

The approach has been used by the government for the past twenty years with its HECS (Higher Education Contribution Scheme). Here loans contingent on future income are given by the government to students.

This approach could be broaden to the wider community and to different areas through giving the right to receive Bank Cash for specific investment purposes to all the population. Bank Cash is required to be invested in areas of need in the community. Today one such investment area is in new renewable energy assets or in ways to save energy or to reduce the level of greenhouse gas in the atmosphere. With Bank Cash almost all renewable energy investments will be immediately profitable because most of the costs of investment in renewables are finance costs of interest and repayments. Repayments of Bank Cash are made from profitable investments which are made more profitable because there is no burden of interest charges on money. This approach makes Renewable Energy investments profitable without any increase in the price of energy through taxation or Emissions Permits.

The approach could be made even more effective if the right to Bank Cash was given to the population in inverse proportion to consumption of mains electricity. This would provide positive feedback where the less energy consumed the more investment is made in ways to save energy.

This approach would be particularly important to small business because small business is better able to take advantage of new technologies and to give higher returns to investors and so attract Bank Cash investment money.

After the approach is shown to work by reducing greenhouse gas emissions other areas that desperately need investment, such as housing for the homeless, investments in conserving water, public transport and education could all be addressed through the same mechanism. If the right to equity loans is distributed widely throughout the community then small business will be able to compete on an equal footing with big business.

Bank Cash for Equity requires a government to back the system. The reason is that the decisions on the broad areas of Bank Cash investment, how it is paid back, and who is to get the right to such loans is a political decision rather than an economic decision. It is a political decision because the right to Bank Cash for Equity investment has value.

Banks Role in Money Creation

Commercial Banks today create most of the money in circulation in the economy. Almost all the money is created through monetizing existing assets with loans secured against property. When the loans are repaid then the amount of money in circulation reduces in the same way it was created.

If interest free Bank Cash is introduced into the system then the incentive for banks to monetize existing assets to increase the money supply will be reduced. That is, it will become more profitable for banks to lend money they have on deposit and not increase the money supply with any loans. The reason it is more profitable is that banks take no risk on Bank Cash and so Bank Cash for equity investment will be preferred method of creating extra money, rather than the banks ability to find borrowers with realisable assets. If banks lend money they have on deposit then their risk is reduced and bank runs become impossible because they can give borrowers loans rather than cash if there is a bank run.

Banks will also earn fees from the distribution of Bank Cash for investment but again with no risk for the banks on the failure of the equity to earn a profit. That risk is taken by the receivers of Bank Cash for investment and for them it is a lost opportunity cost rather than a financial loss of savings or assets.

Government Revenues and Government Infrastructure

Many governments pay a large proportion of their taxes to cover interest payments on infrastructure investments. If governments fund infrastructure with Bank Cash distributed to the population they will be relieved of the burden of interest payments paid from taxes. Governments may even be able to reduce social security payments as Bank Cash for investment can replace direct cash benefits. Governments may even choose to pay off debt by issuing Bank Cash to purchase debt. Bank Cash give governments the opportunity to reduce taxes and potentially almost all taxes collected for income redistribution and infrastructure investment will no longer be necessary.

Bank Cash will make a society that decides to adopt this approach more competitive and no longer reliant on external capital to fund sound investments in its own community. That is it will reduce the need for the Australian economy to borrow money from overseas for infrastructure investment.

However, it is best if governments themselves do not issue Bank Cash to themselves because there will always be the temptation not to invest in infrastructure but to divert the money to consumption. A better way is to give the Bank Cash to the population and let the population invest the money.

As an example, suppose a government wants to fund the construction of a large water storage dam to increase the availability of water to a community. The government could give Bank Cash to itself or it could give it to the citizens who in turn have to invest the money in the dam. Rather than simply giving all citizens the same amount each citizen could be given an amount that is inversely proportion to the person's mains water consumption. This would encourage water conservation and the process could be continued over many years to fund other water saving investments. This process would soon eliminate the need for water restrictions as individuals changed their behaviour to earn water Bank Cash. The same process could be used to fund the purchase of water rights where the Bank Cash must be spent on ways to make better use of existing water. That is, there will be no need for the government to collect taxes to purchase water rights.

Costs and Social Outcomes

Bank Cash systems are inexpensive to implement and could be operational immediately once the political decision has been made to implement them. The running costs would be less than the cost of existing systems because risk is dispersed and repayments are built into the system and are difficult to circumvent.

Implementation costs are minimised because the existing monetary system remains intact. This means there is no disruption to commerce.

As well as benefiting small business these systems can be constructed to benefit all individuals in our society. This contrasts with the current financial system which gives great advantage to wealthy people and large business. This comes about because the wealthy and large business have much greater access to credit than the rest of the society.

The wealthy and big business still have undiminished access to credit. Widening the availability of Bank Cash (or credit) enables everyone to share more equally in new wealth and in the profits from day to day trading and community investment. The wealthy and big business will still be able to invest and will still own existing assets. Nothing is taken from the wealthy and big business. Rather all the community has the same finance costs for new investments and day by day trading.

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