Reflections on Revenue-Contingent Loans for Small Business in the Covid19 Crisis

Bruce Chapman
College of Business and Economics
Australian National University

1 Background and context

We are now enmeshed in the worst combined health and economic crisis in Australian recorded history. The economy is clearly in serious trouble, will be for the foreseeable future, and there are no simple solutions for government policy. While it is clear that major injections of outlays in various forms are critical to mitigating the risk of a very deep recession, it is also the case that extremely high levels of public debt have the potential to severely constrain future budget decision-making.

One of the salient features of the crisis is the high levels of uncertainty, and this will undoubtedly be impacting on business decisions with respect to commercial borrowing to help replace recession-induced falls in revenue. In such an unparalleled risk circumstance it is very likely that business, small business in particular, will be very cautious with respect to extensions of credit obligations. In short, it is a terrible time to borrow, just when the need for financial buoyancy for business is at its greatest.

An essential aspect of borrowing concerns relates to the nature of repayment of commercial debts, which is on the basis only of time. This means that since loan obligations require repayments of a constant amount per period, business will necessarily be at least partially averse to taking such loans through concerns with repayment hardships, and the heightened prospects of default and bankruptcy through the further use of commercial credit.

A pertinent question is: Is there a different design for a loan instrument that overcomes these repayment concerns or borrowers? What follows explains that in concept, and very likely in practice, there is such an instrument and it is known as a "revenue-contingent loan" (RCL).

2 What exactly is an RCL?

RCLs for business are a financial instrument in which money is provided to eligible firms in the form of a loan. However, the loan has a critical feature which is quite different to normal commercial and the government's concessional loans. This is that with an RCL repayments of the debt are required if and only when the firm has the capacity to repay; this is what economists call a "contingent debt".

In concept the idea is similar to the Higher Education Contribution Scheme (HECS), in which students are provided with a benefit, in the form of not having to pay tuition on enrolment for a university degree, which is then paid when graduates are able to afford to do so depending on their future incomes. An RCL would operate quite differently to HECS in practice (explained below), even if the concept is the same.

3 What are the benefits of a RCL for borrowers?

As noted, RCLs are quite different to typical loans, because no or only very low repayments of the debt are required when the financial circumstances of the borrower are poor. This is a particularly important feature in Australia's contemporary economic environment where uncertainty and high variance with respect to the financial well-being of small business are very high. What an RCL means is that firms will be able to access a loan without major concerns or anxieties associated with repayment difficulties, and this also implies that even with very poor financial circumstances the potential costs of bankruptcy from an incapacity to repay a RCL are avoided.

This does not mean that RCL should be promoted as a major replacement of commercial or concessional loans, and there might be good reasons why different financial instruments could be available simultaneously to suit the particular and idiosyncratic circumstances of business. Banks and government could provide loan packages involving both commercial and revenue-contingent loans. This is beyond our discussion, but it should be recognised that the suggestion of RCL is at this time because of the uniquely poor economic circumstances that is today's economic reality.

4 How might an RCL for small business operate?

The first operational point of an RCL is to distinguish this type of loan from the income-contingent loan variety which underlies HECS. This is because HECS uses individual income as the basis for repayment of the debt, which is completely appropriate for a system targeted in the main on wage and salary earners. However, the way forward for a business-oriented contingent debt can't be personal income, and this is because the collection contingency has to to be related to the economic well-being of a small business and not personal incomes.

In 2004, Linda Botterill, Michael Egan and I (Botterill *et al.*) examined what might be the most efficient basis for collection of a contingent debt for farmers in the time of drought, and it became clear that farm property revenue is the best way to ensure the instrument would be effective. Since most farms are simply a subset of Australian small business, the collection issues we resolved are very pertinent to how an RCL would work for all small business. Our analysis suggested quite clearly that it revenue, not profits, is the best forward, now explained.

The key debt collection administrative points with respect to a RCL for small business are that:

(i) The reporting of revenue is a legal quarterly requirement of all business; and

(ii) Unlike what the situation would be for the use of profits, revenue cannot legally be manipulated to suit the timing of repayments for a property.

Here's how an RCL would work. A qualifying business, with eligibility determined by the government, would apply for an RCL. The maximum amount able to be accessed would be capped, and in order that maximum repayments would ensue, this amount needs to be set depending on a firm's past annual revenue experience; this information is easily available from the Australian Taxation Office (ATO). The cap could be something like not more than 50 percent of the average annual revenue of the past 2-3 years of the company, with a maximum set at, say, $200,000 per firm.

The government would provide the loan (which could come from a bank if that mattered for the budget) to the business and the debt would be recorded with the ATO. Every quarter the revenue reported with the firm's Business Activity Statement would activate some debt collection, with the amount set at a given (low) percentage of revenue, for example 5 percent.

This means that, with a 5 per cent of revenue repayment requirement, if a firm borrowed $50,000 and in the first year after the loan became available the firm's recorded revenue was $80,000, the RCL in that year would require a repayment of 5 percent of this, which is $4,000. If revenue in the second year turned out to be $200,000, the repayment obligation would be $10,000 in that year. If this experience was replicated in the ensuing 5 years the RCL would be completely repaid in under 6 years.

With a colleague, I have done some simple modelling using different scenarios of debt levels, interest rates, and collection parameters, and they all come to the same result. This is that RCL organised for small business in the way described would lead to 100 per cent of repayments within less than 6 years, so long as the firms exist in the future and are thus able to repay (more on this below). The details of all this analysis can be found in Chapman and Dunk (2020).

5 Some important points for the RCL lender, the government

There is little doubt that an RCL would be strongly favoured by small business; after all, the policy minimises the risks to firms of borrowing. If designed well there is no prospect of a firm having repayment hardships with respect to such a loan, and this type of financing cannot add to default risk. But what about the lender, the government? What might be the issues for government from this type of public policy financial intervention?

For the public sector, the suggested policy instrument essentially comes down to the prospect that repayments of an RCL are low, meaning that the taxpayer subsidies are too high. It is important that the design of an RCL for small business takes this into account.

There are several design questions that need to be addressed to minimize the extent of RCL non-repayment for small business. These are:

(i) Eligibility criteria: Should RCL be available only to business which have been in existence for a set amount of time (eg 3 years) (I think yes)?

(ii) Should there be a sharing of the risk such the managers/owners of a small business have some personal responsibility of unpaid RCL obligations in the event of a bankruptcy (I think yes)? and

(iii) Should the government legislate that, in the event of a bankruptcy, unpaid RCL debts have a top priority to be repaid out of the sale of assets (I think yes)?.

References

Linda Botterill, Bruce Chapman and Michael Egan (2006) 'Income Contingent Loans for Drought Relief' (2006) (with Linda Botterill and Michael Egan), *Farm Policy Journal,* Vol. 3, No. 2: 59-67.

Bruce Chapman and Madeline Dunk (2020), "Costing Revenue-Contingent Loans', mimeo, College of Business and Economics, ANU.