Hundreds of Thousands of Small Businesses are Near Death

In looking at the health of the Australian economy and its ability to recover from Coronavirus shutdowns it is easy to focus on the big end of town. The insolvency of Virgin Australia, the threats of large retail chains to stop paying rent and the rush of capital raisings on the ASX dominate the business headlines. Yet amongst these big news stories, one jarring statistic stood out in an article I read this week; that the ATO approved over 800,000 payment plans with small businesses in the last financial year. Given the economic damage of the last month, it is likely that this will exceed one million small businesses in the near term. This a dire warning of the pain ahead for large swathes of the economy.

What those who don't run businesses may not understand is that a payment plan is akin to a small business using the ATO as a form of overdraft. In normal circumstances, no small business should have a problem paying the ATO on time as the money owed almost always relates to taxes already collected by the business. For my own small business, GST is collected over the quarter and then paid to the ATO at the beginning of the next quarter. PAYG is held back from employee wages each month and submitted to the ATO in the next month. For a business not to have the money to pay the ATO when they have already collected it signifies substantial financial mismanagement.

For those businesses that have been forced to close by government edict and that already had payment problems this is likely to be the end of the road. Unlike large businesses that can look to obtain fresh capital from share raisings and/or bank debt, small businesses typically have few options. If the business owner is willing to mortgage their home they may obtain finance, but for those without property to offer or who already have substantial debt against their hard assets all doors might be closed. Government support programs can cover a portion of the rent and wages accruing, but they are not nor should they be a complete bailout for poorly managed and poorly capitalised businesses.

Before looking at what should be done it is helpful to consider how we got here. A run of nearly 30 years without a recession all but guarantees that many businesses will have increased their risk tolerances beyond what is prudent. This could be by expanding too quickly, borrowing more and/or keeping less cash in reserve. Well-meaning government actions have distorted market forces and encouraged greater risk taking. Central bank rate cuts and admonishments for businesses to borrow, relaxations of insolvency protections and a light touch approach by the ATO to collecting debts have all allowed the amount of economic deadwood to accumulate. If the Coronavirus hadn't been the spark for this inferno, something else inevitably would have come along to deliver the same outcome.

There are two general approaches to dealing with zombie businesses; extend and pretend or take the medicine. As an old school lender I've seen many times over that "your first loss is your best loss". Searches for miracle solutions almost never succeed at anything other than increasing the eventual loss. We can see this play out with countries; compare the ongoing funks in Greece and Japan, who have failed to take reformative action, with the strong recoveries of South Korea (Asian Financial Crisis) and Iceland (Global Financial Crisis) that took their medicine early. The rejection of requests for government assistance by Qantas in 2014 proved to be the catalyst for that business to address its financial issues.

There will inevitably be calls for more assistance and cries that everything must be done so that jobs are saved. This is wronghead logic that denies basic economic principles. Bailing out poorly managed and poorly capitalised businesses, whether by government handouts or forgiveness of ATO debts, is a deliberate choice to "back losers". The funds for these bailouts come from higher taxes on successful businesses and individuals, the very people we should be encouraging and incentivising not punishing. The lost jobs argument is another fallacy; the staff from failed zombie businesses frequently become employees of the replacement businesses that fill the gap.

As the economy starts to re-open the Federal Government will be required to make tough decisions on which stimulus measures end and when. Saddling future generations with a near trillion dollar debt load to forestall inevitable economic change is neither wise or moral. Tax reform measures such as eliminating payroll tax and reducing company tax, as part of a broad tax reform agenda that shifts taxes away from work (income tax) to spending (GST) and wealth (land tax) should be top priorities. These changes would be a guaranteed way to "back winners" as only successful businesses pay company tax.

The insolvency changes of the last two years need to be rolled back. Protecting employees, suppliers and taxpayers from businesses that don't pay their debts isn't draconian, rather encouraging businesses to steal from other participants in the economy is draconian. The 30 day payment terms being adopted by governments should be legislated for all businesses. Whilst these changes will initially trigger an increase in weak businesses failing, in the long term they will greatly reduce business failures. Well capitalised businesses are far better prepared for future economic downturns than the zombie companies they will replace.

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Disclosure