Australian Government

Productivity Commission

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From the Chairman's Office

20 May 2011

Richard Grant
A/g Secretary
Senate Standing committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT

Dear Mr Grant

Inquiry into Finance for Social Organisations

Thank you for your inviting the Productivity Commission to make a submission to this inquiry by the Senate Economics Reference Committee. The Commission's study into the Contribution of the Not-for-profit sector, published in January 2010, considered some of the issues in the terms of reference for your inquiry. I would draw your attention to chapter 7 of the enclosed report, in particular section 7.3, (pp. 184-195).

The study concluded that the access to capital varied considerably across the not-for-profit (NFP) sector. Large NFPs providing services to their members, largely on a fee for service basis, did not appear to face any significant constraints on their access to capital. For large NFPs providing human services, often with substantial funding support from governments, access to capital was also not considered a major problem. In the main this was because of the substantial assets of these organisations that could be used as collateral. In addition, some large faith-based organisations operate an internal capital market for their members. However, for smaller NFPs providing social services, often on a partly government funded basis, capital for start-up, and to invest in new capacity or trial innovative approaches to service delivery, was difficult to access.

While the inability to raise equity was cited by some organisations as a major constraint, it was the access to debt financing that was a particular concern for these smaller organisations. For smaller organisations providing services on a user pays basis, this appeared no more difficult than for small for-profit businesses. The major difference was the unwillingness of the operators of such NFPs to provide their homes as collateral, which is the common approach for small businesses seeking to raise capital. However, for those NFPs providing social services, the uncertain nature of their funding stream and the lack of assets for collateral combine to constrain their access to capital.

The report made a number of recommendations in regard to improving the certainty of the income stream for NFPs providing what are largely government funded services. It also made recommendations aimed at improving the business planning capabilities of NFPs in order to improve the quality of the business case they put to financial institutions when applying for debt finance (or line of credit). Progress on these fronts is important in ensuring that any efforts to facilitate access to capital by such NFPs can be made on a sustainable basis.

The study considered, admittedly fairly briefly, the scope for new legal forms such as community interest companies, and low-profit limited liability companies, that would allow equity investment under arrangements that limited the legal exposure of the equity holders to the financial obligations of the organisation. However, there is little evidence on the effectiveness of these legal forms from other countries in assisting access to capital, other than from publicly subsidised sources. As the use of these legal forms is still relatively new, it was considered too early to draw any conclusions on the merits of such arrangements.

The study found that intermediary organisations that could assist NFPs to access capital, along with other forms of business advice, to be largely absent in Australia. The failure of intermediary or support services to develop may reflect the ad hoc nature of the funding building capacity in the NFP sector. In part this is because such services require some continuity in funding to be viable, but it is also because most NFPs fail to recognise the value to their enterprise of hiring such intermediary services. The culture in many NFPs arises from a strong community service focus, with many people volunteering their time, or working for lower wages than they would otherwise receive. This culture can discourage investment in the development of the organisation's business and governance capabilities, a tendency reinforced by the reluctance of governments and many donors to fund such 'overheads'.

The study reports growing interest in the social enterprise model that adopts a business approach for the delivery of social services, whether funded by governments, donors or on a user pays basis. While there are a few financial institutions that have a specialty in lending to social enterprises, they still largely require collateral for significant loans. In part this is because of the thin market which prevents the pooling of the risks of loans to such organisations. But it is also because often there is a high degree of correlation in the risks (due to the reliance of many social enterprises on public funding streams), which reduces the gain from risk pooling. In addition, the transaction costs of dealing with small organisations can be substantial.

Overcoming these challenges is not easy, as they require significant growth in social enterprises in order to demonstrate that they are a viable business model with a capacity to service and repay debt. Hence there is a chicken and egg problem. The Commission recommended exploring options to allow philanthropic foundations and trusts to invest in these types of organisations, which is not allowed under the current rules for deductible gift recipients. The logic was that these foundations and trusts would have an interest in supporting activities that have community objectives that they support, but would also have the incentive and skills to monitor the investment. They may also provide additional expertise, or assist in linking business philanthropists with an NFP they invest in. Government support is indirect, but still considerable, as the funds invested were exempted from taxation in the accumulation phase for the foundation or trust.

The potential for significant contingent liabilities and issues of moral hazard were raised in the study in relation to government providing seed funding for social capital investment funds, or investing in the risky tranche of capital for funds that seek to attract private capital. The Commission did not investigate the sustainability of such instruments overseas, with many still in the accumulation phase or subsidised through tax concessions for investors. The potential for superannuation funds to offer a 'social investment' fund as part of their portfolio of fund offerings (similar to green funds or ethical investment funds), was raised as there may be investors who would happily accept a lower rate of return in part of their investment portfolio in order to support what they view as a socially worthwhile investments. However, such an offering may violate the requirements placed on the trustees of superannuation funds to maximise the return on investment.

While these matters were only a small part of a much broader study of the not-for-profit sector, I trust the Committee finds the material in Chapter 7 helpful to its deliberations.

Yours sincerely

Gary Banks AO
Chairman