prosper australia

POLICY MEMO:

COMMERCIAL TENANCY INTERVENTION FOR COVID19 RESILIENCE

24th of March 2020

To state Departments of Premier & Cabinet and Treasury & Finance

Prosper Australia would like to present a solution as to how state governments can provide relief and certainty to businesses while allowing landlords to participate in economic resilience measures.

Our focus here is to prevent longer-term economic recession by ensuring businesses can hold on and not have to close forever under the social distancing measures introduced this week.

While we support calls for a moratorium on residential eviction, evicting a residential renter doesn't automatically provoke job loss - but evicting a business does. This makes commercial intervention far more macroeconomically significant, and more cost-effective, motivating this policy package.

This policy package is highly cost-effective and relatively cheap for the future taxpayer when compared to demand-side stimulus payouts direct to commercial tenants.

In brief, the policy consists of three elements:

1. **A moratorium on commercial evictions**
2. **Cash incentive to landlords: up to 50 cents for every dollar they forego in rent**
3. **State-issued loans to cover the shortfall.**

We hope you take the time to consider our intervention.

In solidarity,

Prosper Australia

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1. CONTEXT

- The Covid19 pandemic has required public gathering cancellations and temporary closure of many businesses.
- The associated economic recession and uncertainty is a major challenge for state and federal governments to intervene.
- Stimulus packages for households and businesses to assist with income losses have been announced at the state and federal level
- Many institutions are calling for a moratorium on residential evictions
- Prime Minister Scott Morrison stated on Friday that landlords, like all Australians, would need to make sacrifices during this crisis but not indicated how

2.PURPOSE

2.1 Breaking the transmission of shock to other parts of the economy.

Classic stimulus packages designed to increase consumption aren't going to work in the context of physical isolation and forced business closures.

In order to keep the economy ticking over, we need to make sure business cash inflows are balanced with their cash outflows. To ensure that otherwise sound businesses are able to survive the short-term hit to their cash flows, *Fixed costs need to become variable or flexible costs.*

The largest fixed cost for the majority of business is rent, and that is the focus of this intervention.

2.2 Equity.

While it is entirely appropriate that the governments pull every fiscal lever at their disposal to prevent an economic death spiral, *fiscal stimulus must not facilitate wealth transfer from future taxpayers to current asset holders*.

This is something we saw in the US and elsewhere with the GFC bank bailouts. The bank's balance sheets were rescued while ordinary people were unable to avoid foreclosure.

Asset holders cannot be insulated from the risk we are all bearing, and it's great to hear our leaders talking about landlords playing their role in what is a collective crisis.

Fiscal policy should enable holders of our most secure and wealth-generating asset base to take a temporary haircut by incentivising private negotiation while minimising the risk to future state budgets.

Government has a role to coordinate a response that helps landlords recognise the complete loss of purchasing power and their tenants' inability to pay; thus cutting short the vicious macroeconomic spiral that is coming. *If the tenant can't pay, they won't pay, but it might well take each and every landlord evicting every tenant to find that out.*

Business owners who own their premises are already sharing in the risk. Our policy intervention provides a mechanism to extend this risk equity to businesses who are tenants.

3. POLICY INTERVENTION

3.1 A MORATORIUM ON EVICTIONS

An indefinite moratorium on commercial evictions gives businesses breathing room while forcing private negotiation. If a landlord doesn't come to the table for good faith bargaining, then the tenant can possess the property without paying rent until the moratorium is lifted.

3.2 CASH INCENTIVES FOR RENEGOTIATION

Renegotiated lease subsidy scheme. For every dollar that a landlord reduces their tenant's rent, the government pays the landlord $0.50 (or some other fraction) to incentivise negotiation.

Original and new leases can be provided as supporting documentation, with money issued immediately and follow up compliance checks done later. Penalties for fraud should include property appropriation without compensation.

Transparency for benchmarking. Rent renegotiation lodgement data is made publicly available but de-identified (e.g. LGA, industry type, the percentage reduction in subsidy) in order to allow landlords and tenants to benchmark against each other easily to encourage fast renegotiations

3.3 STATE ISSUED LOANS

A line of credit for landlords.
A cheap State-administered loan scheme to assist landlords to cover a portion of losses over the moratorium period.

- This could be secured against the property.
- Reduces risk for the taxpayer vis a vis unsecured cash flow stimulus or lending to small businesses themselves.
- Loan repayment could be deferred until the property is next sold.

4.POLICY LOGIC

4.1 IF THE TENANTS CAN'T PAY THE RENT, THEY WON'T

But if it takes each and every landlord evicting every tenant to find that out, the cycle of forced closures of otherwise-profitable businesses will be a key mechanism by which economic contagion would spread.

Rents are negotiated during normal circumstances at an amount that market competition determines is the market's willingness-to-pay for use of a premise. Economists know that as a long-run proposition this competitive process squeezes all the surplus from any tenant that has no special skill or advantage. This means there is no capacity for most tenants to absorb the entirety of the risk of a large sudden withdrawal of demand, a sudden loss of revenue, no matter how temporary.

The simple math is that many tenants' capacity to pay rent is being crunched, and someone needs to pick up the tab. If the tenants can't, they won't, and if they won't, they'll close - with job losses the consequence.

However many landlords are likely incapable of recognising their tenants' and the market's inability to bear what the landlord is asking for (or has historically received). Suburban shopping strips that have suffered years of high vacancies because landlords were unable to countenance a nominal rent cut are a case in point.

The situation presents an economy-wide collective action problem: each landlord looking out for themselves by seeking to preserve their rent, delaying negotiations with tenants, or evicting them in the event of non-payment will drag down the macroeconomic whole; each acting individually will if unchecked do greater harm to landlords in general. An orderly haircut will be the best outcome not only for businesses and employees but also landowners.

The experience of financial crises of debtors calling in loans to a troubled financial institution, and thus worsening its capacity to repay or make other loans, leading to a liquidity and solvency crunch, is analogous. The commercial real estate rent-default dynamic is a real economy version of a financial crisis - but with people losing livelihoods rather than assets losing book value the means of propagation.

4.2: ANNOUNCED DEMAND-SIDE STIMULUS MEASURES WILL NOT BE EFFECTIVE

Demand-side only stimulus will not be effective in restoring aggregate demand, because the withdrawal of spending right now is a first-round shock caused by restrictions on households and fear of infection - not by inability to pay. The withdrawal of business spending is a consequence that no accelerated depreciation policies or lump-sum grants can remedy.

The first round shock is not a withdrawal of consumption based on worsening economic prospects, i.e. based on a tightening budget constraint or based on a voluntary increase in the savings rate, a precautionary action in an uncertain environment. It is, at the current moment, an entirely involuntary decrease in consumption and increase in savings caused by the logistical difficulties of spending money right now.

Throwing money at households or small businesses to ease a non-binding budget constraint will simply not succeed in solving this problem. When this consumption 'sniffle' deteriorates into a macroeconomic cold (or worse), household demand-side stimulus will be necessary and the 'precautionary saving' story will become a major part of the dynamics. But demand-side subsidies will not arrest the immediate reasons why people are not spending right now, and why spending will remain suppressed during the lock-down months. This is not the GFC repeated, and the GFC advice - go early, go hard, go households - is not the right prescription now.

4.3 THE CRITICAL VARIABLE IS CASH INFLOW VS CASH OUTFLOW

The basic mathematics of business closure from a tenant's point of view are about recurrent cash inflows versus cash outflows from remaining open, and about whether this equation remains positive or turns negative.

Demand-side household subsidies target the first part of the equation. They are an attempt to boost cash inflows - and will not be effective (or cost-effective) for the reasons described above. Lump-sum grants directly to businesses may extend cash-on-hand for some time, but will not change the week-by-week equation of whether to remain open, which is about recurrent inflows and outflow.

The more effective alternative enacted by the proposed policy package is to go cost-side, by reducing cash outflows. This means keeping the equation positive by lowering business costs, in particular the one cost that is set without reference to any real opportunity costs - the rent.

Enacting a rental haircut in a fair, quick, and orderly way will minimise the public cost, and is the key means of achieving the macroeconomic goal.

Economists understand that rent is an arbitrary amount reflecting the market's willingness to pay for something scarce. During normal times, all business tenants have revenues exceeding variable costs, and the difference is what ultimately determines the rent payable. But market rents do not reflect the risk of recessionary demand shocks, and tenants have no buffer to absorb a revenue shock while continuing to pay rent.

The proposed policy targets two distinct situations with two different policy goals.

First, some businesses even now have revenues exceeding their variable costs and, aside from the need to pay a rental price negotiated during normal times, could remain open. For these, the risk is that their landlords' demands to pay the rent forces these businesses to shut their doors. And the policy task is to ensure that these otherwise-viable businesses are not dragged under, with implications for their staff and suppliers and second-round effects on the macroeconomy, thanks to contracts struck during normal trading conditions that are unable to be fulfilled right now.

Second, some businesses trading profitably in normal times will now have revenues temporarily below their variable costs. These will close their doors for now even if their rent were immediately reduced to zero. The policy task is to make this closure temporary, in order to accelerate the subsequent recovery. We need businesses’ working capital, their lines of credit, to last as long as possible, and to ensure ordinarily-profitable business tenants are not sent into bankruptcy by their landlords - because upon resumption of normal trading conditions we need them to quickly return their staff to jobs and return their businesses to being productive contributors to aggregate demand.

In short, for these two tenant situations the economy needs rent - a fixed cost, established during normal conditions - to vary, and to vary as much as necessary to keep ordinarily-profitable businesses from shedding staff.

4.4 COMMERCIAL RENT - THE MOST EFFECTIVE POINT OF INTERVENTION

The policy proposal specifically targets the nexus between landlords and their commercial tenants, which will be - indeed, already is becoming - a critical vector for transmitting the current spending shock to the broader macroeconomy.

A hasty resolution to tenants' financial distress, which require coordination / central direction or incentives, means the 'pulse' of lost spending in the short-to-medium term will be transmitted back to landlords, who will absorb the hit without major second-round macroeconomic effects such as job losses, a generalised loss of confidence, and destroying capacity for a fast restart.

A slow, unco-ordinated, market-led resolution would instead present a collective action problem: each landlord's incentive to maximise their rental income will leave tenants either insolvent or in a state of such uncertainty that many will close, with macroeconomically significant second-round effects on employers and suppliers as well as a permanent loss of capacity. The long-run outcome, paradoxically, will be worse for landlords too by destroying potential for a rapid economy-wide recovery.

The policy proposal makes the first outcome more likely by subsidising landlords’ voluntarily entered into losses, thus 'greasing the wheels' of rent renegotiation and providing tenants greater certainty. In a word, the policy acts to convert what is normally a fixed cost (rent) into a temporarily variable cost that does not push tenants into insolvency and eviction.

4.5 PACKAGE DESIGN - INCENTIVES

In this policy package, item 1 (the moratorium) encourages landlords to engage in renegotiation of rent facilitated by item 2 (the rent renegotiation subsidy). Unco-operative landlords will be faced with the prospect of their tenants occupying the property rent-free until the moratorium is lifted at some as-yet-unknown date in the future. Item 1 is the stick, item 2 is the carrot.

Item 3 is a discretionary addition that might solve liquidity problems for some landlords with zero public cost. If property owners rely on rent to service debts or as income, this item lets them continue accessing the same cashflow but in three parts: rent, grant/subsidy, and loan.

4.6 PACKAGE DESIGN - SCOPE

This proposal focuses on commercial tenants and landlords only, not on residential properties. It involves landlord-side subsidies in preference to grants to tenants, or across-the-board mandated rent waivers for a fixed duration.

The reasons for this design are that many residential tenants, such as work-from-home permanent employees, will not suffer any significant loss of purchasing power in the short term - the risks are concentrated on casual workers and those laid off from the hardest-hit industries. Across-the-board subsidy for residential rents would therefore be poorly targeted spending. Moreover, these pressures on residential tenants are a second-round effect, caused by the first round of impacts: the commercial bankruptcies and layoffs.

Our policy targets the first round problem directly. If jobs on the high street can be preserved, the call for and the cost of residential support will be lesser.

In contrast to the residential sector, cashflow and ability-to-pay pressures will be more consistent across the commercial sector. Even so, pressures on commercial tenants will differ by place and industry, so across the board grants or waivers would be poorly targeted.

A uniform subsidy that replaces 50% (or some other nominated percentage) of what landlords concede to their tenants will be an equitable way to subsidise landlords' losses across different places and industries, without wasting spending on tenancies not in distress (e.g. supermarkets). It is a more cost-effective form of spending than grants to tenants or landlords, and the fixed percentage subsidy makes it faster and less administratively cumbersome than any top-down allocation that attempts to gauge need and design grants to fit, such as the announced state government business support funding pool.

The policy provides a market-led, decentralised solution to writing down commercial rents - to enacting a rental haircut - in a rapid, orderly, and proportionate manner. Relative to rent waivers, it supports landlords more, with less unfair redistribution from landlords to tenants that do not really need it. The instrument sets the right incentives, and maximises the bang-for-buck of government spending.

Finally, as noted, the role in amplifying an aggregate demand shock into a larger recession is far more significant for commercial than residential tenancies. Evicting a residential renter doesn't automatically provoke job loss - but evicting a business does. This makes commercial intervention far more macroeconomically significant, and more cost-effective, motivating this policy package.

5. CONTACT

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