FINANCIAL REVIEW

— Opinion

Australia needs banks to invest in businesses, not houses

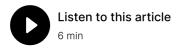
This country doesn't need more luck to drive productivity, it needs strategies to help finance SMEs, and to make better use of existing energy infrastructure.

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How do we make the Lucky Country even luckier? Our challenges are many and include halting the decline in per capita living standards, along with the massive erosion in housing affordability. Simultaneously, we need to manage the net-zero transition and other long-term fiscal challenges.

One obvious way to kick-start growth is to direct every lever of policy and every spare dollar of public spending towards productivity and capital deepening. At the same time, we need to observe the wisdom of the late, great Charlie Munger [https://www.afr.com/link/follow-20180101-p5eob8] – that incentives matter.



Time to focus banks away from housing and into business investment. Peter Braig

The good news for 2024 is that there are some obvious, win-win policies that would surely meet with Munger's approval. Our current favourites reduce the cost of capital for small and medium-sized enterprises (SMEs) and lower electricity bills for businesses and householders. All of this achieved without any new public subsidy.

One idea is using the tax system and Ross Garnaut's cash-flow tax proposal [https://www.afr.com/policy/economy/radical-business-cash-flow-tax-pushed-20200417-p54ku5] to underpin huge equity investment in business capital investment spurring homegrown supply chains and employment.

The cash-flow tax replaces the company tax for Australian companies. We model that the proposal is revenue neutral over a decade, if not earlier, and would also "buy" huge future gains in living standards.

It allows for the full and immediate deductibility of all capital expenditures incurred by businesses operating in Australia. This is a massive benefit for businesses investing in capital-intensive projects and big tech, such as those associated with the net-zero energy transition.

It allows businesses with negative cash flows a tradeable tax credit they can sell to profit-making enterprises. Effectively, the tax system becomes an incubator for innovative SMEs, during their tough formative years.

It pays for full deductibility by disallowing all expenses related to interest costs, depreciation, and transfer payments. These are very often rorted by global parent companies through their local subsidiaries via their tax advisers, the big four accounting firms. Our last estimate of this impost is that it cost the federal government about \$20 billion annually. So, the Garnaut cash-flow tax proposal turns the screws on global tech enterprises with massive local revenue paying negligible company tax.

Small-business lending

Second is using banking regulation and risk weights to make SME lending cheaper.

Before financial deregulation in 1983, Australia's banking system allocated twothirds of its capital towards local communities and small businesses. In other words, the focus was on value-added production and settlement. Back then our banks were required to take their social licence seriously. Indeed, that is why we had state-owned banks and building societies. Private banks maintained expensive branch networks to compete for business.

Forty years after financial deregulation, Australia's banking system allocates around three-quarters of its capital towards <u>residential home loans</u> [https://www.afr.com/link/follow-20180101-p5eqo3] (about half of which are made to investors). Sectoral profit margins are globally embarrassing. All of this contributes to acute imbalances in terms of housing affordability and affordable housing via inflating the asset stock. Sadly, no one raises an eyebrow.

One obvious way to lower the cost of debt capital for SMEs would be to recalibrate prudential risk weights so that they become far more favourable to their lending. That would also motivate our banks to roll up their sleeves and begin again to better understand the local business needs of their customers. And it might also take some of the heat out of residential property prices.

Keeping the lights on

Third is using the existing electricity infrastructure to minimise the cost of transitioning and to keep the lights on.

The intervention of Australian governments in the National Electricity Market (NEM) through public investment and revenue underwriting arrangements has now rendered it useless as a price signal for new investment. The subsidies

required to stimulate investment in renewables have also necessitated underwriting coal-fired power stations to ensure the lights stay on.

Energy Minister Chris Bowen continues to pour subsidies

[https://www.afr.com/link/follow-20180101-p5en9w] into renewables capacity. But the lack of adequate firming and long duration storage means he must spend even more on subsidies to coal-fired stations to ensure they provide dispatchable back-up. Talk about incentives.

EnergyAustralia's managing director, Mark Collette, has made the vital request that Australian governments recognise the need for the foreseeable future for strategic reserves of coal-fired power stations. Given the Europeans have been forced to learn this lesson in recent years, the reality here should be clear.

Of course, maintaining coal-fired power station reserves has very real additional benefits for our grids.

First, the spinning turbines at those power stations provide critical inertia to our grids that keeps them stable. With the closure of coal stations and the influx of intermittent, synchronous renewable energy, the Australian Energy Market Operator and the Australian Energy Regulator are using Band-Aids to maintain grid stability.

This takes the form of investment by networks in expensive synchronous condensers, as well as paying battery owners large sums for frequency control services. All these costs are borne by grid users. Maintaining coal-fired power stations as at least reserve power units offers the opportunity for them to provide essential inertia.

Second, the spinning turbines should soon be able to be powered, not by coal, but by renewable energy stored as heat. We are aware of one thermal energy storage company in discussions with some owners of coal stations to demonstrate its technology.

That technology can store energy sourced from renewables (grid supplied or behind the meter) at up to 2500 degrees and is designed to drive utility scale turbines for an extended period. If those trials are successful, we may just have a storage technology that can be truly scaled on a cost-effective basis and offering short, medium and long duration storage to facilitate the transition of the grid.

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