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FRIENDLY LENDING: BRINGING MICROFINANCE BACK HOME

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Summary

To make sure the whole country feels the benefits of Britain's continuing economic growth, those with disposable income must be free to help their fellow citizens who have little or none.

Too many people in Britain today are stuck living on what they earn or receive in benefits, unable to borrow enough to secure their future or run a business.

Friendly Lending is a new kind of tax relief, which encourages direct lending by taxpayers to both social entrepreneurs and those on low incomes in the UK. It is a bold new twist on the success of microfinance in developing economies and draws on Kiva's recent, fruitful decision to bring microfinance to the US.

Friendly Lending provides a new source of finance to a sector of the population where both financial access and entrepreneurial activity are low. In return for helping the less fortunate in their own communities, Friendly Lenders get more control over how their tax is spent. And if they support successful projects, they can also spend their money how they like after two years.

If this proposal wins a prize, the prize money will be used to help create a platform for Friendly Lending in the UK.

If you are poor in Britain today, you will find it hard to borrow money for a new venture. Not surprisingly, you also have a lower chance of becoming an entrepreneur.

In every country of the United Kingdom, the most deprived 20-30 per cent are far less likely to be self-employed. For the poorest 10 per cent, the level is about half the national average, with just five entrepreneurs for every hundred people.

Britain has a shocking 1.5 million people who are entirely financially excluded. That is three times the population of Edinburgh. People with no bank account. No sort code. At least a third of the financially excluded are stuck on welfare.

The financially excluded are only the worst-off. Recent attention has revealed the plight of the just-about-managing. These are the dedicated people whose work keeps the country running. There are six million just-about-managing households of working age. They sit in the bottom half of the nation's income distribution, on low to middle incomes. They are not reliant on benefits, but struggle to live modestly whilst spending almost everything they earn just to get through the month. They lack savings and disposable income, thus investing to secure their future is a luxury they can't afford.

Unsurprisingly, the government has tried to tackle the twin challenges of financial access and entrepreneurial activity among the least well-off, but both problems remain.

Sir Humphrey's limits

Considerable political energy and taxpayers' money has been spent to encourage entrepreneurship at the bottom of British society, yet the level remains intractably low. Most recently, the 2016 Mone review brought in a voice from the business world, and one with personal experience of escaping poverty, to provide fresh insight. The report offered tweaks to the status quo but failed to deliver a radical breakthrough.

Access to finance has also received attention, with many worthy initiatives, including tax breaks such as Social Investment Tax Relief (SITR). But SITR only extends to individuals, not companies, requires a three-year term and is structured to favour larger investments.

In America, however, a breakthrough has begun. A new, non-state model of microfinance combined with digital platform technology is proving effective in ways that government intervention has failed to achieve.

Microfinance gets a platform

Digital platform technology - the enabling force behind global successes such as Facebook, Twitter and Kickstarter - is significant because it is ever more accessible across socioeconomic boundaries. It cuts out bureaucratic middlemen and its efficiency and automation allows it to process many small transactions at scale. These platforms permit far more direct connections between citizens. These can be as trivial as liking each other's selfies, but also as transformative and valuable as e-commerce and crowdfunding.

Microfinance, like crowdfunding more generally, is nothing new. The Great Exhibition of 1851 was crowdfunded. And Jonathan Swift, the author of Gulliver's Travels, started his own tiny microfinance fund in the early 1700s. He offered small loans to poor Irish tradesmen, charging no interest. Although Swift could only help a handful of people, he began a larger tradition of Irish loan funds. And today, digital platform technology has enabled microfinance to expand as never before.

So far, microfinance has had its biggest impact in developing economies. There, platforms like Kiva have shown that aggregating many small direct loans to local entrepreneurs can have powerful effects. But in recent years, a few experiments have started exploring the model's potential in developed economies.

Notably, Kiva began introducing a programme of its zero-interest-rate loans to American entrepreneurs in 2009, and rolled out its national US platform in September 2015. The lack of any potential gain for lenders removes Kiva from the costs and barriers of regulatory scrutiny by the SEC watchdog, making the initiative practical. To date, two thirds of Kiva's US borrowers belong to ethnic minorities. More than half are women. Two fifths have only been in business for a few months, without the financial history needed for a commercial loan. And many are from poor and rundown areas.

And yet, while the UK has a thriving alternative finance sector, it lacks any platforms of this kind.

There is no obvious regulatory barrier to blame. Zero-interest-rate loan platforms don't need regulating. While our own financial watchdog, the FCA, has yet to formally approve this for the UK, the US precedent and informal indications from the FCA's regulatory sandbox suggest that this would be a formality.

The technology exists. As does the political will to find a solution. But the solutions of politicians and civil servants default to the top-down and bureaucratic.

We need a new vision: a radically different kind of policy that supports microfinance while increasing economic freedom for the population at large.

I call it 'Friendly Lending'.

Friendly Lending

The worst possible response to the promise of Kiva's US expansion would be to create a government-run microfinance platform and grant it a monopoly. That way lies inefficiencies and inevitable overspend.

Friendly Lending proposes a different way forward: simply change how microfinance is taxed.

Friendly Lending tax relief will only be available to the users of approved platforms. These platforms must aggregate small individual payments into zero-interest-rate loans for entrepreneurs on low incomes and social enterprises in poor and deprived areas.

In recognition of the fact these loans offer zero interest and are high-risk, investors in the platform are granted 100 per cent relief on income tax up to a capped amount.

This cap is set at £1,000, and is flat. All individuals subject to income tax have access to the same level of tax relief.

Additionally, to expand Friendly Lending's potential reach, companies and financial institutions have access to their own version of the scheme. For corporates, the cap is set by reference to a to-be-determined percentage of turnover or net profit. For other types of institutions, alternative measures such as one based on assets under management would be introduced.

As a condition of the relief, the money must remain invested in the platform for at least two years, calculated from the end of the tax year in which the loan was made. After that time, if the loan has been successfully returned, the investor can remove the money from an escrow-type account and keep it for their own free use, with no capital gains liability. This rewards lenders who support projects with real promise.

It is a requirement of a platform's right to operate that it automates the escrow process, basic certification of borrowers, and the claiming of tax rebates.

Ideally, with the efficiencies of platform technology and integration support from HMRC, it would be possible to institute an automated rebate system that could operate as a reverse PAYE – 'Keep As You Lend', or KAYL.

For instance:

- Someone earns a salary of £25,000 in the tax year 2016-17.
- They are required to pay 20 per cent income tax on £14,000 = £2,800 in total, £233 paid monthly by PAYE.
- However, from July-November 2016, they loan £200 each month on a qualifying platform to support several promising social enterprises and individuals, using their full Friendly Lending allowance for the year.
- As they are signed up to KAYL, this is automatically credited to their income tax PAYE in each following month, reducing the bill to £33.
- In April 2019, if the money has been returned and not lost to bad loans, they can now withdraw it for their own use tax free.

The creation of this bold tax exemption will turbocharge the entrepreneurial microfinance sector in the UK and support the development of competing platforms. It will allow individuals and companies a greater measure of control over how their taxes are spent. And because lenders are incentivised to lend to successful projects, it will help direct that tax money to where it can be most effectively invested.

Conclusion

The poorest third of our society needs better access to finance. It also suffers from a lack of successful entrepreneurs. But restoring financial access and the vital, problem-solving initiative of small businessmen and businesswomen has proven beyond the power of the state. Friendly Lending offers a new and more practical approach.

Friendly Lending is not a one-size-fits-all solution, but a liberalising method. It trusts in the diversity of individual initiative.

Friendly Lending's success will provide a desperately needed source of microfinance to those who currently have no easy option. It will also produce ripple effects. Local employment and training opportunities will be created. New initiatives will answer local needs. Successful ventures will encourage others who have ideas worth trying. A greater entrepreneurial spirit will also provide new pressure for the resolution of longstanding problems that now cause innovators difficulty - for example, disputes over the right of council tenants to run small businesses from their homes.

More microfinance will also save central government money. In 2012 the Centre for Economic and Social Inclusion conducted a study for the Fredericks Foundation, which gives loans to entrepreneurs who have been turned down by conventional lenders. The study found that over a three-year time horizon every £1 invested in financing a Fredericks Foundation loan saved the public purse at least £2.90 and at times as much as £6.50 claimed in benefits. And this did not include indirect tax revenues or savings.

Achieving this outcome through platforms that allow direct support and encouragement from other citizens brings additional benefits. At a time when politicians are keen to bind the country together, Friendly Lending creates a new and direct connection between economic classes. It highlights not just the challenges of poorer areas to the rest of society, but also their hopes and aspirations for a better life. It then opens up a channel which can serve not just for the transfer of money, but the potential for informal mentorship and other kinds of voluntary community assistance. Above all, it makes realising the projects of the poorest in society an entrepreneurial challenge that the nation can grapple with, and learn from, together.

Friendly Lending effectively ring-fences a small percentage of personal and corporate tax so that its expenditure is under taxpayers' direct control. Although it still limits how the money may be spent, this represents an important increase in economic freedom.

Friendly Lending increases economic freedom immediately by allowing those who participate to select the specific ventures in which they will invest. And if the loans succeed, it returns the tax money after two years to the free use of the owner.

Friendly Lending also provides valuable second-order effects to promote the values of a free society: it emphasises self-help, and, by permitting those involved to keep money returned at the end of the period, it draws attention to how money can be created, not just shared around.

This is an initiative beneficial to the poorest that increases economic freedom for all. It inserts a thin but powerful wedge into the centralised system of income taxation. Those who take part will be struck afresh by the inventiveness of everyday citizens when given the freedom to create effective, affordable solutions to poverty in their own communities.

Indeed, I am so personally committed to this platform-driven, non-state model for relieving poverty that if my entry is fortunate enough to win, I will donate the prize money to help fund the creation of an experimental UK microfinance platform.

Friendly Lending is a tech-enabled, twenty-first century policy with old-fashioned liberalism at its heart. After years of failed, state intervention it is time for a breakthrough that gives individual citizens more room to help one another. It is time for Friendly Lending.