Catalyst Research

Enhancing Payroll Protection:
Sustainable Financial Wellbeing

Policy Analysis Memo

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EXECUTIVE SUMMARY

While the short-term effects of the pandemic are receding, small businesses will continue to experience the aftershocks of a recession for some time. Among their challenges are getting finances back in order, hiring employees, and making payroll. Government relief programs such as the Paycheck Protection Program (PPP) are already beginning to end and are unsustainable in the longer term. At this critical juncture, policymakers should focus on longer-term, sustainable solutions to small business challenges, particularly those that make use of private sector innovations.

This memo calls attention to a segment of the financial technology ("fintech") industry that is innovating in the area of payroll, both to help small businesses free up this capital in creative ways, and to give workers access to money they earn closer to real time. We call special attention to an emerging area named "pay asset finance" which exists in the U.K. (but not yet in the U.S.) that essentially accomplishes both of these things at once. In the U.K., this kind of fintech is government-backed by what is essentially payroll insurance.

We propose that small business payrolls are a critical national economic asset that should be protected by the federal government. Because of the great potential to help small businesses access working capital to grow and hire more employees, the Small Business Administration (SBA) should experiment with a U.S. version of pay asset finance through a pilot program that determines the market for and efficacy of such payroll innovation in this country.

> *"You go in main streets and towns all over New Jersey, you have closed small businesses, it's outrageous, and it's going to take a much longer time to recover from the economic problems than it did, in retrospect, from COVID itself."*
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> - Chris Christie, former Governor of New Jersey (Fox News, 5/13/21)

BACKGROUND: THE SMALL BUSINESS COVID RECESSION

The most evident lingering economic result of the COVID-19 pandemic is a U.S. small and medium-size business (SMB) recession. These businesses, commonly defined as having less than 500 employees, make up 99% of all U.S. businesses and employ roughly half the American workforce - but they are also open to risks, such as not having enough business savings or access to other capital during leaner times or an emergency. Thus, the health and economic consequences of the pandemic have left the Main Street economy somewhat in chaos, with bankruptcies, closures, layoffs, revenue losses, and business model evolution, but also new business starts, new hiring, and an accelerated digital transformation.

As we move out of the pandemic period into a reopening world, SMBs will begin to settle into a more normal rhythm. But some lessons from the pandemic will not be soon forgotten - the need to be prepared, the need to access working capital, the need to be agile and adapt to changing conditions. Innovation will be a more important part of Main Street than ever before, now that most SMB owners and leaders have realized how critical new ways of thinking and doing have been for resilience during the pandemic. This will be especially important in the near future, with businesses struggling to hire employees, which will increase the competitiveness of job offers with regard to pay, benefits, and intangible perks.

The primary topic of this memo is innovating around the core problem of SMBs (and even somewhat larger businesses): timely, or perhaps recurring, access to affordable working capital, not just during emergencies but on an ongoing basis. In effect: How do we innovate to create a financially stronger world?

THE ONGOING PROBLEM OF ACCESS TO WORKING CAPITAL

One of the core challenges most SMBs have is ongoing access to working capital to pay for regular, predictable expenses, such as labor costs ("payroll"), to mention one of the largest. While the percentage of a small business' budget going to payroll varies by industry, labor costs at businesses that are heavily service-based such as restaurants, bars, or theme parks can be as high as 40% of total costs.

The pandemic period has made it even harder for SMBs to make payroll. While the U.S. federal government has provided a 'safety net' to these businesses through the Payroll Protection Program (PPP) and other relief programs, these are merely a stopgap and no guarantee of future success. Moreover, while these programs are generally winding down (as of early May 2021, PPP is effectively out of funds), there is also evidence that minority, underserved, veteran, and women-owned businesses faced barriers to accessing them in the first place, resulting in an ongoing acute need in these communities.

That said, the federal government cannot sustainably "make payroll" on behalf of all the small businesses in the country who need help, and relief programs such as PPP were necessarily more about temporary survival rather than focusing on forward-looking investment and planning for growth. The longer-term solution is policy innovation that helps private sector entities take the lead to innovate and grow while backstopping them through government agencies and programs, particularly those of the Small Business Administration (SBA), which supports SMBs and the economy mainly by connecting entrepreneurs with funding in various ways.

Now that the U.S. is largely emerging from the pandemic and entering a major "reopening" phase, it is more important than ever for policymakers to explore longer-term and more sustainable solutions for the Main Street economy of SMBs. Below, we detail three interrelated challenges that currently exist to the free flow of capital through the economy, with the specific focus on SMBs accessing the capital necessary to meet their ongoing payroll obligations.

EMPLOYER ACCESS TO CAPITAL TO OPERATE THEIR BUSINESSES

In general, SMBs do not have large amounts of business savings to fall back on when an emergency occurs or sales dip significantly. For example, across the 50 largest U.S. metro areas, only 26% of SMBs have at least three months of cash readily available. Before the pandemic, 21% of SMBs did not have a business banking relationship with a bank or credit union. And during the pandemic, many SMB owners dipped into personal savings to keep their businesses afloat.

Small employers frequently struggle to access working capital needed to pay their employees and other expenses, as those funds are present but unavailable for use because they are obligated to pay payroll two weeks in advance or more. In this regard, SMBs are at a disadvantage relative to larger or more established businesses that are "credit rated" and have additional means to access capital at their disposal.

While there are reasons that larger businesses have more access to capital and creative financing, at the core this situation is inequitable to smaller businesses, putting the latter at more risk of failure. What is needed are innovative access-to-capital solutions for established, credit-worthy SMBs - most likely those with over 20 employees and predictable revenue and costs - that create a more equitable playing field.

REAL-TIME ACCESS TO PAY FOR EMPLOYEES TO PAY THEIR EXPENSES

According to the 2020 "Getting Paid In America" survey conducted by the American Payroll Association (APA), 68.7 percent of American workers would experience financial difficulty if their paychecks were delayed for a week - in other words, they are "living paycheck to paycheck." Even worse, about 5 percent of workers reported that their paychecks are in fact sometimes or often late. (And similar to PPP for SMBs, stimulus checks, while helpful, were a stopgap and not a long-term, sustainable financial solution for working Americans.)

“Waiting for payday” is a common saying that means exactly what it sounds like - while money has been earned, it has not been paid out in real time but rather is paid bi-weekly or in some other regular fashion, and workers must wait to receive it. Depending on the method of payment, it may take even longer to access funds (cashing a paper check, etc.). But schedules for paying for ongoing needs like rent, food, and child care do not revolve around workers’ paydays, and do not go away when an employer pays late.

What happens when workers have to pay bills between paydays, or need quicker access to cash for some reason? Some work a second job to close the gap, others turn to cash jobs or other work in the “grey market,” and still others turn to financial solutions like using overdrafts or payday loans, which often serve to put them even more in debt. The market for these services is vast, with market size measured by revenue of the Check Cashing & Payday Loan Services industry estimated to be $18.2 billion. About 17 million Americans (5.5%) of Americans have used a payday loan in the past 5 years, and moreover these loans have also historically targeted marginalized communities - low-income workers, people of color, and women.

BALANCING THE GOVERNMENT BUDGET - OR AT LEAST TRYING TO

During the pandemic, the government expended a fair amount of national treasure in the form of aid to businesses and workers, and even the U.S. government has its financial limits. The PPP program alone has distributed $782 billion via 10.8 million loans (this is not exactly the same as the number of SMB recipients, because some have received more than one loan), supporting payrolls, for the most part. Total government support tops a trillion dollars.

The point of all of this government support for businesses should be obvious - to keep them in business. But as the pandemic is ending and government support is drying up, SMB expenses haven’t fundamentally changed, and most are still at some level of risk of being unable to meet their obligations and even closing for good. And even SMBs that have made it this far are in debt in many cases.

Government should do what it can to support these businesses in new ways so rather than PPP prolonging the inevitable, SMBs can have a more sustainable outlook and future, which includes sustaining their own revenue (and paying taxes or having customers pay sales taxes) and employing workers (who in turn pay the government personal income taxes). All of this would ultimately be good for the government’s balance sheet.

THE DIGITAL SAFETY NET AND FINANCIAL INNOVATION

The U.S. is slowly but surely reopening to both work and play. But while the U.S. economy is recovering, it is far from fully recovered. Even in the best of times SMBs face massive headwinds, and as the country looks ahead to a post-pandemic world, millions of businesses - and their employees - remain at high risk of going bust. Access to working capital will be critical during this ongoing recovery phase. As we move forward into this reopening world, all of the entities described above - employers, employees, and governments - would be well served to “shore up their balance sheets” and move toward a more sustainable financial future.

A noteworthy phenomenon documented by Google and the Connected Commerce Council (3C) during the pandemic has been the presence of a different kind of ‘safety net’ - a Digital Safety Net - that allowed many SMBs to survive and even thrive during the challenging times of 2020-21. The Digital Safety Net refers to the collection of diverse services, platforms, and tools that SMBs have used during the pandemic to increase resilience and perform better financially (sales, revenue, etc.) and operationally (hiring, training, etc.). It is made up of everything from websites and social media, to video conferencing, online hiring platforms, e-commerce tools, data analytics, and much more.

In order for SMBs to continue to survive and thrive in a reopening world, the Digital Safety Net is the best way to give SMB owners and leaders the tools they need to continue to adapt, grow, employ, and contribute to the broader U.S. economy. Financial innovation has the potential to be an important part of this. Smart policy that helps secure SMB payrolls can be paired with fintech solutions to address critical gaps SMBs face.

Here we call attention to an aspect of financial innovation that has been evolving in the U.K. but is not as fully developed in the U.S., termed "Payroll Fintech" - essentially, the application of financial technology to the critical payroll space. Thus far, startups in this space have focused on employee access to capital, through "early direct deposits" (access to a paycheck up to two days early), "on-demand paychecks" (instant access to wages earned), "salary advance" (short-term credit of 2-10X a monthly paycheck), and even getting paid in cryptocurrencies like Bitcoin.

A newer type of Payroll Fintech that goes beyond serving just the worker to serving both employers and employees simultaneously (and in turn, governments, as described earlier) is called "pay asset finance," which not only gives workers instant access to earned wages, but also releases working capital to businesses. The crux of the problem is that SMBs must keep cash on hand to make the next payroll (so they can't put it to use elsewhere) and meanwhile workers cannot access pay in real time and must wait to get it on "pay day." However, while businesses can often defer payment or negotiate terms with, say, their suppliers, "pay asset finance" allows businesses to, in effect, defer payment to employees by financing it through a form of government-backed insurance, which gives the businesses more working capital. As an additional benefit, the fintech provider also tracks the payroll in real time and, through their financial partner(s), gives workers access to it. Importantly, this is not a loan for either the company or the workers.

PROPOSING A 'PAY ASSET FINANCE' PILOT PROGRAM AT SBA

It is important to note why pay asset finance doesn't yet exist in the U.S. In the U.K., this kind of "payroll protection" has government backing. Thus, fintech companies can innovate in concert with that policy and its government guarantee. The U.S. doesn't currently have a form of government backed payroll; however, in effect, the pandemic-era PPP was a version of that, as it gave loans to SMBs with the express purpose of guaranteeing paychecks for workers. As we move into a reopening and rebuilding phase, the government may wish to explore some form of payroll protection, if only as a pilot program, in order to ascertain the demand and utility of such a payroll fintech innovation in the U.S.

Such a pilot program would best be carried out by the SBA, whose mission is to "maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses." Unlike traditional government-backed loan programs facilitated by the SBA, the primary purpose of a privately funded pay asset finance pilot program would be to provide low-cost access to extra cash flow liquidity for small businesses by enabling them to defer payroll in 30, 60, and 90 day increments.

Over the longer term, such a program conducted at scale would also conceivably:

- Reduce other kinds of business relief programs over time
- Drive increased tax revenue to state and federal governments through SMB success
- Help governments fortify their balance sheets by empowering private sector fintech innovation to support SMBs more with increased funding offerings

The additional free flow of capital for SMBs and workers ultimately benefits the U.S. economy in direct and indirect ways. SMBs make more revenue, which is a direct benefit to the economy, and they will tend to hire more people, which grows the economy indirectly.

As exemplified by first-mover fintech innovators in the U.K. and Europe, such a program could also offer workers early access to their already-earned net pay through on-demand pay programs. This would have wider economic benefits, as workers accessing pay in real time *increases* daily capital flow into the economy - i.e., it increases the velocity of money. And in addition, many workers will spend their pay at SMBs, promoting a positive growth cycle and a more stable economic recovery for the country.

FINANCIAL WELLBEING AND A SUSTAINABLE FUTURE FOR MAIN STREET

The COVID-19 pandemic changed our world, and while we are reopening and recovering, some changes will stay; not the least of which is the use of and reliance on digital innovations (AKA, the Digital Safety Net). While we work within this new normal, we need to be aware of our successes and shortcomings in this last year.

While federal aid like PPP was indeed as a lifeline for small businesses, it is not enough to achieve sustainable economic recovery and growth. Financial innovation, particularly around payroll and a potential pay asset finance program, could address many issues at once - enhance access to working capital, reduce dependency on predatory payday loans, reduce disparities in access to capital, and numerous other possibilities.

Furthermore, innovative fintech products such as pay asset finance tend to not exclusively apply to small businesses, but companies of all sizes. Converting some or all of a large company's payroll into financed assets can deliver significant liquidity to support growth while also increasing choice for businesses looking to free up working capital. For example, a publicly-traded company with excellent employee benefits might finance its contributions to employee retirement accounts. In other words, these new asset classes can have broad, innovative effects on the economy and deliver financial wellbeing to large swaths of the population.

We now have the opportunity to think about business finance differently, in part by innovating through private-sector fintech companies and new kinds of public-private partnerships. This evolution has the potential to affect an even higher purpose: increasing the overall wellbeing of workers, employers, and the country in a thoughtful and sustainable manner.