incentives for growth

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Chapter 7

Tax incentives for social investment

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Tax incentives for social investment

This chapter examines the legacy of the social investment task force, set up in 2000 by the Chancellor to encourage more private investment in disadvantaged communities. In particular, it explores the emergence of the community development finance sector and the impact of one of the task force's key recommendations, community investment tax relief.

Three years after going live, CITR has raised £38 million of new investment. But its potential is far greater than that. This chapter identifies the barriers facing CITR and what more needs to be done – by the government and by the community development finance sector – to maximise its impact.

Social investment task force

The social investment task force was set up in 2000 under the leadership of Sir Ronald Cohen, founder and former chairman of Apax Partners. It was initiated by HM Treasury at the request of the UK Social Investment Forum, the New Economics Foundation and the Development Trusts Association.

I was a policy adviser in HM Treasury at the time, and sat as an observer on the task force. I was also responsible for following up the task force report, and helped push through the early implementation of its five key recommendations. Incidentally, the task force had the good sense to make only five recommendations. This provided real focus and should serve as a model for the future.

The remit of the task force was "to set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment … and to unleash new sources of private and institutional investment". The task force was also asked to explore innovative roles that the voluntary sector, businesses and government could play as partners in this area.

The task force's five recommendations to the Chancellor in October 2000 were a package of interlocking initiatives. They were designed to create a system that could drive investment in underinvested communities and encourage entrepreneurial growth and financial inclusion. The government responded to the recommendations very swiftly and positively.

The recommendations were:

1. To introduce community investment tax relief (CITR).
2. To help set up community development venture capital funds.
3. To encourage disclosure by banks of their lending in underinvested areas.
4. To provide greater latitude and encouragement for charitable trusts and foundations to invest in community development finance.
5. To provide support for community development finance institutions (CDFIs).

Progress since 2000

The task force's recommendations have made a significant impact in a short time. But as this summary of progress shows, there is still more to do.

1. In just over three years, CITR has raised £38 million of private investment in CDFIs, for on-lending to businesses in disadvantaged communities. But the potential of CITR is much greater than this. The rest of this chapter discusses the challenges facing CITR in more detail.
2. The UK's first dedicated community development venture capital company, Bridges Community Ventures, was set up in 2002 and has now invested its first £40 million fund. Bridges recently announced it had raised £33 million for a second fund. This emerging community development venture capital sector is perhaps the most impressive achievement since the task force made its report in 2000.
3. Some banks have voluntarily started to disclose information about their lending activities – for example, Barclays, HSBC and NatWest/RBS. But not all have done so. This has led some to press for legislation compelling banks to disclose, along the lines of the US Community Reinvestment Act.
4. Charities have been active in developing new financial instruments such as Futurebuilders. But there is still more to do, to promote community development finance among the charitable sector.
5. The Community Development Finance Association was launched in 2002. It has 73 members, representing the vast majority of the UK's community development finance institutions, and has been key to the recent growth of the sector.

Community development finance sector

The community development finance sector is now worth £450 million. It has supported more than 18,000 businesses and households. According to the Community Development Finance Association, it has created 11,000 jobs and sustained 88,000 more. This finance,

which is delivered by CDFIs, has levered an extra £285 million of funding from other sources into businesses and households in the UK's most disadvantaged communities.

CDFIs are specialist finance providers that serve deprived areas. One of the key aims of the task force was to increase these bodies' access to capital; that is why they were earmarked as the initial recipients of CITR investments. CDFIs are therefore critical to the tax credit's successful delivery. But as this chapter shows, they do not yet have the capacity or volumes to trigger a step change in the economic and social revitalisation of the communities that they serve.

Community investment tax relief

Community investment tax relief is a relatively new tax incentive. It was enacted in the 2002 Finance Act, and went live in April 2003, when the first CITR deposits were raised by Charity Bank. CITR aims to encourage individuals and corporate investors to invest in accredited CDFIs, which then provide finance to enterprises that operate in or for disadvantaged communities.

The tax relief is generous. It comes in the form of a reduction in the tax liability of individuals and corporations, totalling 25% of the capital provided, spread over five years (5% a year).

For example, an investment of £100,000 would entitle the investor to a reduction in tax liability of £5,000 each year for five years. This is worth 8.33% a year gross for higher-rate taxpayers, 6.41% a year for standard-rate taxpayers and 7.14% a year for main-rate corporation taxpayers.

Investments may be in the form of loans, equity investment (either shares or securities) or deposits (for those CDFIs that are banks). Since all CITR investments are committed for five years, they can be recycled again and again, resulting in a much greater impact than single donations.

Take-up of CITR

So far, the take-up of CITR has been quite limited – in terms of investment raised, the type of investor, the number of active CDFIs and the amount of on-lending.

First, CITR has raised £38 million of private finance (spread over five years). But in 2000, the task force estimated that it would raise £1 billion over that period. This was clearly

overambitious, and now makes the £38 million look disappointing. The Community Development Finance Association says that a further £15 million to £20 million could be raised by the end of 2007, bringing total CITR investments to around £55 million.

Second, most of the £38 million has been raised from individuals, rather than corporate investors. The tax relief has so far failed to engage fully with the corporate sector, and needs to be more actively promoted and targeted at corporate investors.

Third, only a minority of CDFIs are actually using CITR. Of the Community Development Finance Association's 73 members, 23 are accredited to use the tax relief, but by September 2005 only 11 of those had actually raised CITR investments.[34] It is the more mature institutions that have been most successful at raising finance under the scheme. For example, the vast majority of the total £38 million has been raised by just one institution – Charity Bank. The many younger CDFIs must now work hard to get to the stage where they can also raise private finance. The Community Development Finance Association is working hard to increase demand for CITR among these bodies, but progress is slow.

Fourth, not all of the £38 million raised by CITR has actually been invested in disadvantaged communities. By the autumn of 2004, less than half of CITR funding had been on-lent to social investment entities. This is because, in many cases, there can be limited demand for CDFI investment – partly because there simply are not enough businesses on the ground for them to invest in. We highlighted this problem in our city markets report *Business Location in Deprived Areas* (2006), which looked at some 30 areas.

Challenges

The Community Development Finance Association has identified these key challenges facing CDFIs and CITR:

- Implementing and embedding a new scheme: Clearly, it takes time for a new tax incentive scheme like this to take hold. This is especially true of the CITR.
- Raising the profile of CITR among individuals and companies: Awareness of the relief is growing, but the sector must find new ways to boost awareness if the scheme is to reach its potential – especially among corporate investors.

34 The 11 CDFIs using CITR are: Charity Bank (£25 million), Triodos (£3.8 million), Social Investment Scotland (£2 million), Big Invest (£1 million), Co-operative & Community Finance (£1 million), Business Finance North West (£600,000), Enterprise Fund (£600,000), Black Country Reinvestment Society (£63,000), Aston Reinvestment Trust (£58,000), Aspire (£50,000) and London Rebuilding Society (£16,000).

- **Growing capital demand:** CDFIs must increase their ability to deploy capital effectively, and do more to identify enterprises to invest in. Increasing the demand for CDFI finance will take time, as younger institutions achieve investment readiness.

Another key challenge is the funding position of the CDFI sector. For CITR to succeed, the CDFI sector needs to be secure. Until recently, the Phoenix fund has been the primary means by which the government supported the sector. Following the formal wind-up of this fund in March 2005, the government allocated £11 million of transitional support to the sector for 2006-08, but the long-term funding position is still uncertain.

I wrote to the Treasury about this in December 2005. The official Treasury reply (January 2006) stated:

In the long term, the government wants to see the CDFI sector generally building toward a more sustainable platform – including leveraging private finance. The government is reviewing – along with RDAs, banks and other investors – what long-term options may help in progressing this.

This suggests that CDFIs will have to become less reliant on public funding, and use tools like CITR to diversify their funding options. Only then will the community development finance sector become truly self-sustaining. However, these institutions are still in their infancy and the tax relief scheme is complicated. This combination is particularly difficult, and means that progress towards sustainability will probably be quite slow.

Barriers to sustainability: CDFIs

There are several key issues facing CDFIs, which together explain their position. These issues will need to be addressed, if they are to secure their long-term sustainability.

- First, most CDFIs are new. Community development finance is an emerging sector. Nearly half of these institutions (42%) have been financing for less than two years. This means that many do not have an established track record, and are seen as very risky.
- Second, CDFIs are typically very small, run by one or two people. Their capacity is very limited, especially when it comes to dealing with complicated tools like CITR. Most will need to grow further in order to become investment-ready. The Community Development Finance Association is developing a programme of capacity-building for specific institutions, to help develop their investment strategies. This will take time.

- Third, many CDFIs have been overly reliant on capital grants. This is unsustainable. As the sector consolidates and grows, more institutions will need to raise investment from a variety of sources – not just grants and loans, but private investment too. The CITR can help them do this, so they need to make more use of it.
- Fourth, CDFIs are not well-known. This is partly because of their small scale, but also because of their branding and marketing. Basically, these institutions are bad at promoting themselves. Few people have heard of them. Interestingly, in the US, where the model was born, the sector is considering a rebranding. Perhaps CDFIs should rename themselves "community banks"?
- Finally, the terminology around CDFIs can be unhelpful, and could explain the limited take-up by corporate investors. For example, potential investors are confused by terms like "ethical investment", "social investment" and "venture philanthropy". This tends to marginalise CDFIs, placing them in the framework of corporate social responsibility rather than mainstream commercial investment. Instead, CDFIs should market themselves more commercially, and present CITR proposals as a sound financial investment – with low but sustainable rates of return, and a social return too.

These five factors help to explain why most CDFIs have been unable to make more significant use of tax relief. Let's now turn to some of the specific problems related to CITR.

Barriers to sustainability: CITR

These factors help to explain the limited impact of CITR so far:

- CITR is a very niche, narrow and specialist tool. Its design has prevented it from becoming a major, mainstream finance vehicle.
- Its range of applications is too limited. CDFIs cannot use CITR money for property-backed investment, equity investments in profit-making businesses, home improvement loans or personal loans.
- It does not have a champion within government. For example, there is no adequate resource in central government to deal with CITR queries, which can take months to handle.
- It has been poorly marketed. Such a specialist tool needs smart marketing. An effective marketing campaign would target independent financial advisers, for example – a key audience if CITR is to take off. It would also tell the tax relief story more clearly and simply. How does CITR benefit people directly? Why does it matter? How can investors get involved?

Proposed changes to CITR

The Community Development Finance Association has proposed a number of changes to the design of the tax relief. For example:

- allowing CDFIs to invest a proportion of their portfolio in social (residential) housing;
- extending the period of tax relief for investments from five to 10 years; and
- extending CITR to include equity investments in for-profit companies.

Extending the tax relief to personal finance could also be a big potential market. The Treasury consulted in 2005 on extending CITR to include this market. There was a good deal of support at the time, but the consultation also raised some issues that are still being examined by the Treasury and HM Revenue & Customs. In the 2005 pre-budget report, the Treasury said:

The government has consulted on extending CITR to the personal lending activities of CDFIs. This indicated support for an extension and highlighted a range of practical issues that need addressing. The government will continue to consider the case for, and practicalities of, this extension.

It would appear that the government is in no rush to extend CITR to personal finance.

The US Community Reinvestment Act

As mentioned above, a much more radical option would be to compel the banks to disclose their lending activities in underinvested communities. During its initial work, the social investment task force found that the US Community Reinvestment Act had been a significant driver in identifying banks' activities in underinvested areas.

The act was passed because of concern that banks were taking deposits from, but not lending to, deprived communities. It effectively mandates banks to provide services to low-income communities, and to disclose their lending and investing activities in those areas. Introduced in 1977, and revamped under President Bill Clinton's tenure, the Community Reinvestment Act is loved and loathed in equal measure.

Although its impact on financial exclusion is not clear-cut, it does seem to have brought banks into areas they would otherwise not have entered – and once they are there, they soon realise they can make a profit. It has encouraged US banks to acknowledge the importance of CDFIs. And it is credited with causing an additional $1 billion to flow into

some of the US's poorest communities.

The social investment task force recommended that UK banks disclose information on their lending in under-invested areas. If banks did not do this voluntarily, the task force said such disclosure should be made mandatory, along the lines of the Community Reinvestment Act.

Some banks have disclosed some information about their lending activities – for example, Barclays (2001), The Co-operative Bank (May 2002), Unity Trust Bank (2003), NatWest/RBS (2003) and HSBC (2004). But not all have done so. This makes meaningful comparison between banks' activities very difficult. Last year, the National Consumer Council and others proposed a universal service obligation – along the lines of a Community Reinvestment Act – that would mandate the banks to do more.

So far, the government has avoided going down this road. And on balance it remains an unlikely outcome, given the government's broader concerns about excessive regulation on business.

Conclusion

When Gordon Brown agreed to Ronald Cohen's proposals for a CITR in 2000, we always knew it was going to be an experiment. The risk of low take-up was higher than the risk of excessive demand. The success of the tax relief was going to rely to a large extent on the ability of the CDFI sector to adapt and grow. We knew this would be a big challenge.

Six years on, the experiment is working. CITR is taking hold, and the CDFI sector is growing. CDFIs got a major boost when the Treasury agreed to CITR. But the tax relief scheme has also asked CDFIs some challenging questions, about their market penetration, their track record and their capacity. The sector is still in a process of transition. It is still too marginal, and too specialist. It needs to become more mainstream, and more commercial. The CITR is also too specialist, and niche. It needs to be expanded and made more flexible.

Meanwhile, the mainstream banks present CDFIs with a real challenge. They are now getting better at serving traditional CDFI markets. This is good news on one level, as we all want to see increased access to mainstream banks. But it could also lead to reduced demand for specialist vehicles such as CDFIs. To survive, they will increasingly need to seek out new, and potentially riskier, investment opportunities. This will be difficult for such a new and emerging sector.

On a brighter note, the Commission on Unclaimed Assets, also chaired by Sir Ronald Cohen, offers the prospect of additional future funding for CDFIs – although this new stream will not become available for at least another 18 months, and the demands on it will be significant. Nevertheless, with Sir Ronald at the helm, CDFIs are in a good position to benefit.

So there is plenty more to do, to safeguard the community development finance sector and to make the case for an improved CITR. As the comprehensive spending review approaches, that case needs to be made more strongly than before.

The Smith Institute

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