The Organics Tax Credit

new economics FOUNDATION

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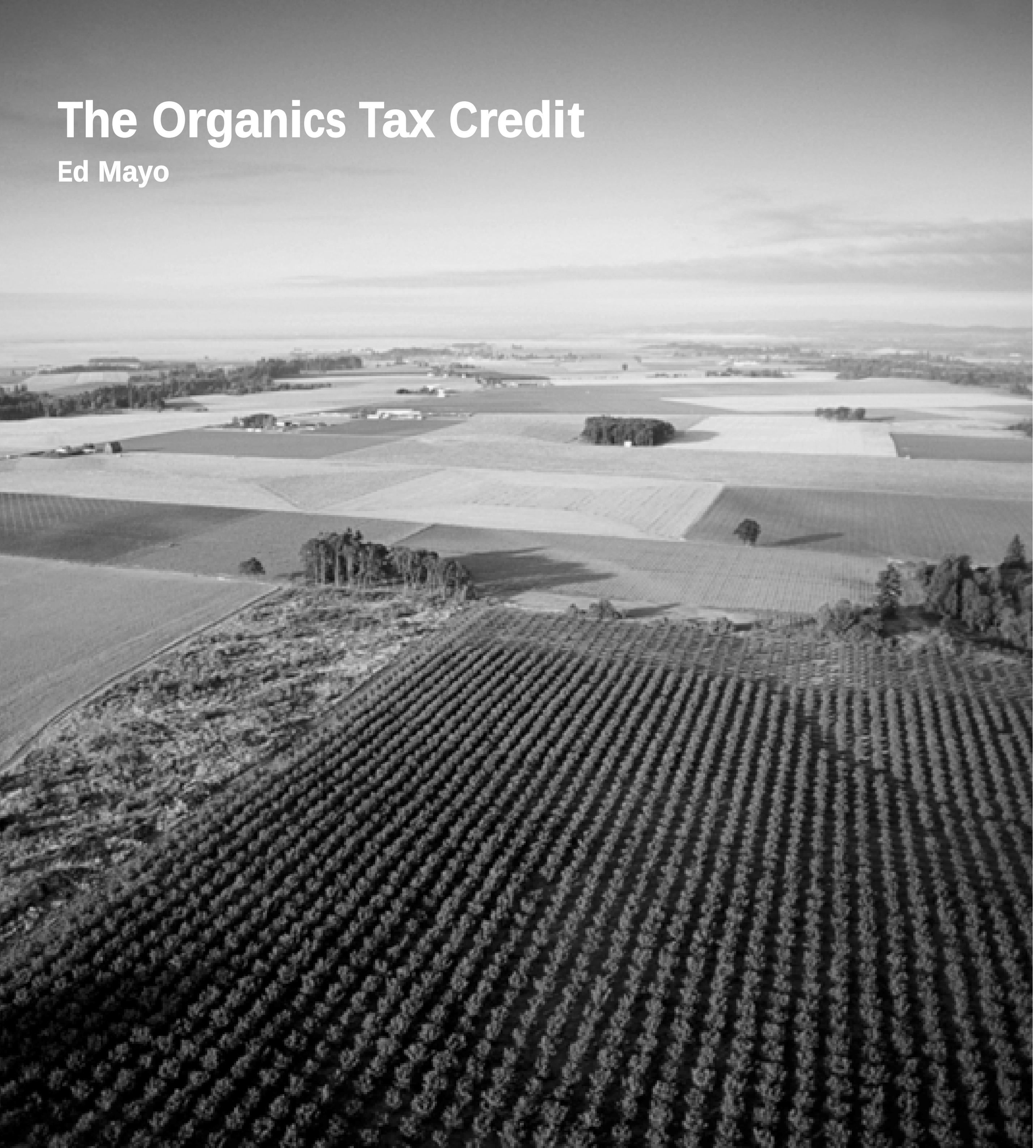


foreword

Farmers are entrepreneurs. They have the knowledge, skills and passion to run their business in tough and competitive market conditions. And yet, it is probably the case that policy support for farming, in the form of intervention subsidy and grant schemes has not always created the incentives and market conditions for the entrepreneurialism of farmers to succeed.

Organics is a case in point. In many ways a success story, organics can and should grow significantly in years to come. Moreover, the organics sector offers opportunities for on-farm enterprises or value-added, co-operative processing that can enable farmers to retain more of the food pound. And yet the investment for these enterprises is hard to come by.

Drawing on the success of the Dutch green investment scheme, which has attracted over £1 billion of investment, the Organic Tax Credit goes with the grain of our thinking, in terms of looking for creative market-oriented options to grow the domestic organics sector for the benefit not just of farmers but of society and the environment more widely, on a sustainable basis.

This might represent a more effective use of government subsidy, helping to create incentives to unlock private sector investment and align government intervention with the entrepreneurialism, self-help and imagination of farmers. The New Economics Foundation has led thinking in the UK on new models of social enterprise and I commend this short report as a creative, big idea for the future.

Elliot Morley MP
Parliamentary Under Secretary (Commons)
Department for Environment, Food and Rural Affairs

The Organics Tax Credit

1 Organic farming brings proven benefits in terms of the environment, employment and rural economies, bio-diversity and public health.

2 Organics also reduces the negative externalities of conventional farming. Pesticides leaking from farms, for example, cost £120 million each year to remove from drinking water, and these costs are paid by water consumers.

3 Last year organics broke through the ceiling of one per cent of food sales, but 75% is imported and the overall market is small and underdeveloped in relation to any wider transition of farming towards sustainability and public health.

4 Subsidies are available for organic conversion, but these have proved slow and limited. Only 3% of land under farming is organic or in the process of conversion to organic.

5 They also do not support the creation of value-added enterprises on farm, which is likely to be the best route to raise farm incomes. Only 9 pence in the pound, according to Professor Jules Pretty, currently returns from food sales to farms. Organic enterprises, co-operative ventures and sales direct to consumers, such as in the growing number of organic farmers markets, are effective diversification strategies for UK farms.

6 Organic enterprises of this form bring added benefits to the rural economy. A 'local money flows' analysis completed by the New Economics Foundation and Soil Association tracked the impact of a Cornish vegetable box scheme, Cusgarne Organics, based near Truro. This found that £10 spent in the local organic box scheme in Cornwall generated around £25 for the local economy – compared to approximately £14 for spending in a typical supermarket.

7 Commercial finance for organic development and for organic enterprises has developed from a small base. Leaders have been specialist finance groups, such as Triodos Bank, which has twenty years' experience in the organics sector. However, many remain unorthodox propositions for finance, returns are low or uncertain and venture capital is rare. For this reason, a significant finance gap exists for would-be organic entrepreneurs and farmers.

As more widely in the small enterprise sector, it would appear that undercapitalisation is also a leading contributor to business failure.

8 There are reasons for this finance gap. This is a young sector, not yet able to demonstrate, nor in many cases deliver, a consistent return on capital. The specialist funders, social banks or community loan funds, are not yet of a sufficient scale to be attractive partners to banks and other sources of mainstream finance.

9 There is the potential for social investment to create a virtuous circle, expanding the number of investors willing to consider social as well as financial benefit and using that investment to meet social need. This is an update of the Robin Hood model, taking from the rich and giving to the poor, but on a voluntary basis and with a return on capital.

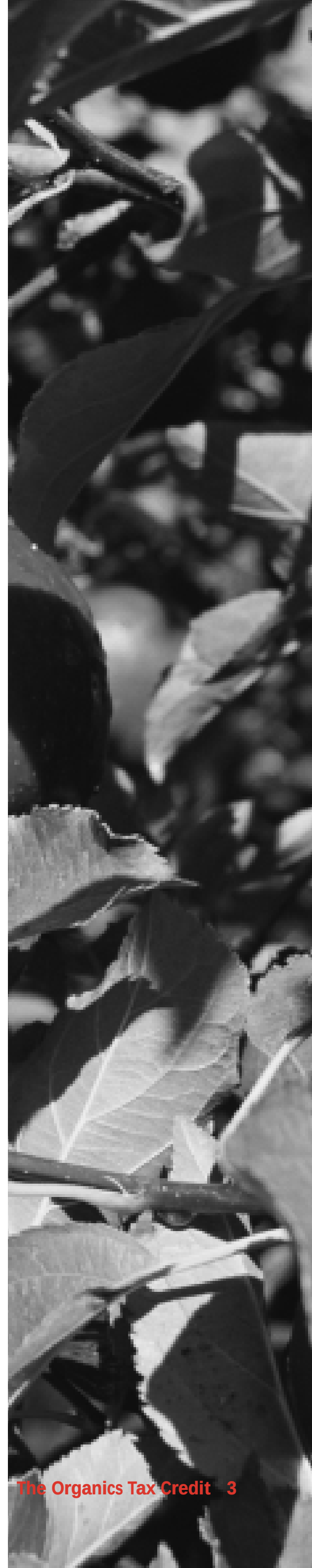
10 However, there is a very limited pool of this kind of low return social investment to draw on. Moreover, it is unlikely that, left to its own devices, this pool will expand rapidly.

11 The positive growth of social investment in ethically screened equity funds (now worth over £3.3 billion) is based on a proposition of a proven rate of return and low rate of risk. It is not straightforward to take funds, even at a reduced return, from risk averse social investors and lend that in innovative but demonstrably risk-free ways for organic development.

12 To expand the pool of social investors willing to lend low return capital of this form therefore and achieve social benefits from this, there is a need for government intervention. The clearest way to do this is through tax credits.

13 While the introduction of a tax credit is not expected to change investment habits overnight, it could encourage a gradual shift in investment behaviour, open up new investment markets and promote private/not-for profit partnerships.

14 International experience shows that tax credits can attract additional social investment. These are set out in Annex A. There are also a number of examples of tax credits used for other purposes in the UK.



15 The Dutch green investment scheme has run since 1995. The scheme exempts private investors from paying tax on their interest or dividend derived from green investment funds. The investors pay no tax on the net dividend or interest received from the fund. The scheme has provided a source of low cost finance for the green funds which forms the basis for providing green loans at favourable interest rates.

16 The funds are supervised by the Dutch Central Bank which invest at least 70% of their funds in green projects. A project is considered green when it meets the criteria of the Green Projects Regulation and it has received a green certificate from the Ministry of Housing, Spatial Planning and Environment. It covers primarily organics and wind farming.

17 Since the start of the green investment scheme, 6 banks have introduced green funds of a combined value of over £1 billion.

18 Recent analysis of the scheme has suggested that its strengths lie in its simplicity, the capacity to promote competition and to be market orientated. The scheme's simplicity is a draw for both the projects and the funds which invest in them. Green funds can judge easily whether projects will qualify for the tax exemption making it easy to incorporate into a financial product. The scheme has effectively promoted competition between green funds. Without such competition there would be less of an incentive for green funds to translate the low cost of funds into low interest rates in green loans.

19 These examples from overseas show clearly how well thought out and clearly defined programmes can achieve real growth in the quantity of new investment to new sunrise sectors such as organics.

20 A similar model is the Community Investment Tax Credit, developed by the New Economics Foundation and taken up by the Chancellor in the April 2002 Budget.

21 The Community Investment Tax Credit encourages private investment in under-invested communities, via intermediaries which can invest in both not-for-profit and profit-seeking enterprises.

22 The **objective** of an Organics Tax Credit would be to increase the flow of affordable credit to organic farms and enterprises.

23 It would therefore operate as an incentive to investors, who would invest through accredited 'green funds' run by regulated financial institutions. Such funds would operate in competition for lending to organic entrepreneurs, helping to ensure competitive rates for lending. Investment would be patient capital, structured for a minimum period of years.

24 There are a number of issues in the design of an appropriate tax credit, in particular issues around eligibility, targeting, selection and scope.

25 **Eligibility**. Tax credits could be attached to specific enterprises producing products which fulfil criteria for organic certification.

26 In a similar way to the US tax credits, they could prioritise rural areas already recognised as regeneration priorities. The strength of this approach is in its ability to **target** the tax credit in areas of greatest need, but it effectively excludes legitimate projects in other areas, the deadweight and displacement costs would need careful assessment. On balance, we do *not* recommend this approach.

27 One method for **selection** for tax credits is on a competitive basis which has been used widely in the US and corresponds to the challenge fund approach of the Phoenix fund for the Community Investment Tax Credit. The strengths of such a process lie in the ability of viable projects or institutions to self-select.

28 **Scope.** Tax relief could be applied to different levels of investment. Experience from overseas indicates that the value of a tax incentive for social investment rests on its ability to attract and retain "patient" investments. Tax relief on the lump sum would therefore act as the greatest incentive for investors motivated by the financial return and flexibility afforded by a tax credit system.

29 There is evidence to draw on to suggest that such a tax credit would be used by potential social investors in the UK and that it would bring considerable additionality.

30 Research from Charities Aid Foundation, NCVO and an NOP survey by NatWest shows that givers/investors are encouraged by tax effective measures as well as by ease of giving and the relevance to their own experience and feedback about how money is used. Evidence from Investors in Society and the results of research commissioned by Charities Aid Foundation and Barclays Bank, indicate that social investment also draws out money which is not presently available to charity. It is money that may be stored in savings that can be attracted into investment (with the right incentives) into vehicles enabling it to work for society now and in the future. Further, respondents indicated that over time they could expect to lend as much as 5 times the amount they give to charity – potentially unlocking a substantial new stream of resources.

31 We estimate that £50 million of tax-credit in each of five years could support £1 billion of investment, which would dramatically increase the resources available for organic enterprise.

32 Extending the tax credit system provides an opportunity to use the tax code creatively to harness finance and investment for social goods, allowing the markets to internalise the benefits of corporate responsibility, and, potentially, wider exchequer savings from the reduction of negative externalities.

Incentive Taxation: Tax Credits for Social and Environmental Goods – Overseas experience

	Who qualifies for the tax credit	Aim	How	Beneficiary	Level		Length of programme	Commitment of funds	Who administers
New Markets, US	Community development investment entities	Increase investment in new market areas	Eligible entities and selection on competitive basis	Individual and corporate investor	30% of investment	Equity	10	7-21	HUD
Empowerment zone tax credit, US	Profit and non-profit enterprises	Increase employment opportunities in particular areas	Fulfil eligibility and qualification criteria	Employer	20% plus, $15K wage bill per employee	N/A			IRS national award
Low Income Housing Tax Credit, US	Property development projects	Increase volume of low income housing through increased investment	Fulfil eligibility criteria and qualification criteria	Individual and corporate investor	Determined monthly, currently 9%		Ongoing	10 years	
Community Development Corporation tax credit, US	Community development corporations	Increase investment in community development programmes	Fulfil eligibility criteria and selection on competitive basis	Investor	5%	Loan & equity	5 year pilot	10 years	HUD
SOLIDE, Canada	Local social venture capital funds	Advice and capital for new businesses to create jobs at a local level	Statute based fulfilment of eligibility criteria	Individual investor	Up to 50% (15% national, 15% Quebec, further 20% if pension based)	Loan	Ongoing		
Cigales, France	Investment club members	Increase investment in small, start-up enterprises	Fulfil criteria of investing in start up companies	Individual investor	25%	Equity			DTI equivalent
Green investments, Holland	Certified green projects, administered by banks setting up funds	Increase investment available for green projects	Accreditation by projects in receipt of certification	Individual investor	Exemption from income tax on return from green investments	Equity			Dutch Central Bank (fund administration), Ministry of Housing, Spatial Planning and Environment (certification)

The New Economics Foundation (NEF)
Founded in 1986 out of the anti-globalisation counter-summits alongside the G8 and now recognised as one of the UK's leading think-tanks, the New Economics Foundation (NEF) works for a new model of wealth creation, which is human scale, socially inclusive and ecologically sustainable. It has taken a lead in helping to establish new coalitions and organisations, such as the Jubilee 2000 debt campaign, the Ethical Trading Initiative and the UK Social Investment Forum. As much a do-tank as a think-tank, NEF focuses on 'proposition' rather than 'opposition', developing and piloting practical ideas at the local level.

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