Building Community Equity:

The Practical Aspects of Tax Credits and Public Incentives as Mechanisms for Encouraging Private Investment in CED Initiatives

September, 2001

Prepared for the

Canadian Community Economic Development Network (CCEDNet)

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Executive Summary

Introduction

This report responds to one of the five policy recommendations made at the Canadian Community Economic Development Network (CCEDNet) National Policy Forum held in March, 2001. The purpose of the meeting was to create a policy environment to broaden and deepen the impact of community economic development (CED) innovations in Canada. One of the Forum's key recommendations was to explore a new tax incentive program that would encourage individual and/or private sector provision of equity capital to CED projects. This discussion paper serves to bring some initial clarification to the question of equity financing in a CED context.

Overview of Equity and CED

For CCEDNet to develop future initiatives utilizing equity for CED purposes, it is important to begin by defining the term "equity". At its most basic, equity represents a capital transaction in which an ownership stake is exchanged for capital.

In general, equity investments are riskier than other kinds of investments. As a result, equity investors will seek to make investments in those companies likely to generate the largest returns on investment in order to offset a higher degree of risk. From a CED perspective, this poses problems since equity investment has not been evenly distributed within the population. Rather, it has tended to gravitate towards a narrow group within the larger population, denying capital to those outside the established power structure. Over time, this has a tendency to focus investments and capital in certain areas, and to potentially encourage investors to look away from smaller centres when they place equity investments.

However, it should also be pointed out that equity investments have two distinct advantages from a CED perspective. First, they provide an avenue for very early funding of new ventures and initiatives - funding that would not otherwise be available through debt. Second, they can help to keep capital (money) in smaller communities if and when equity investment opportunities can be found those smaller, often disenfranchised communities. One example of such opportunities is referred to as Community Economic Development Investment Funds (CEDIFs), which are programs designed to facilitate millions of dollars of equity investments in disenfranchised communities for CED purposes. More specifically, a CEDIF is a pool of money raised by individuals, groups and businesses for investment in a community.

Although traditional economic relationships and large institutional players have prevented the benefits of equity from accruing to all entrepreneurs and communities equally, this does not suggest that equity in and of itself is flawed. Rather, equity can be a powerful tool for local empowerment and economic growth, building opportunity and community capacity. To achieve this, however, CED practitioners must utilize tools and models (like CEDIFs) that bypass the inherent weaknesses and faults of the established financial power structure, in order to facilitate the flow of capital from those who hold it, to those who can make use of it at the community level.

CED Equity Tax Credit Programs

A tax credit is essentially an agreement between a government and a taxpayer to reduce the amount of taxes to be paid in exchange for an expenditure or investment in an arena where the government seeks to increase such investment.

Tax credits are useful from a variety of perspectives. For government, it is a way of encouraging investment in a field where government resources may not be sufficient to meet goals and objectives. For corporations, tax credits may make certain activities affordable (e.g. Research and Development). For individuals, tax credits are a way of reducing personal income tax costs.

In the CED context, this has led to the introduction of tax credits for those who make equity investments in Community Economic Development Investment Funds (CEDIFs). The underlying rationale is that while CED is good for the community, government resources alone may be insufficient (or inappropriate) for certain kinds of CED investment. The combination of CEDIFs and tax credits is thus a mechanism to encourage investment in CED by rewarding those who make equity capital available with a tax credit.

An example of a CEDIF program is the Equity Tax Credit program established in Nova Scotia in 1993, which allows for provincial tax credits of 30% to residents that invest in Nova Scotia small businesses. The credit allows equity investment in corporations, co-operatives and community economic development initiatives. Thus, the program provides an avenue for individuals and community groups to raise capital for local investment purposes.

A different type of tax credit program is New Hampshire's Community Development Investment Program (CDIP), which is the major funding program for community development projects in that state. The CDIP enables New Hampshire's businesses to donate funds or property, in lump sum payments or pledged over a predetermined period, to fund economic development and housing projects throughout the state. Contributions made by businesses entitle them to a 75% state tax credit.

Most provinces and territories offer a variety of tax credit programs linked to equity investments and, to a lesser extent, CED investments. The most common of these is a tax credit for funds invested in labour-sponsored venture capital funds. Such credits can be found in Nova Scotia, New Brunswick, Quebec, Ontario, Manitoba, Saskatchewan and the Yukon. British Columbia offers a similar venture capital tax credit. Aside from tax credit programs, there are a number of distinct provincial and federal business assistance programs targeting rural and disenfranchised communities.

Implications of Equity Financing for CED

It is clear that equity investment provides significant opportunities for CED initiatives. The experience of New Hampshire and Nova Scotia, among others, shows that equity investing for CED purposes can be effective. While still a relatively new concept, equity investing for CED has led to the creation of a variety of CEDIFs across North America and Europe, and opportunity exists for more to be created. However, there are practical issues related to equity investing for CED purposes that need to be overcome. These issues include regulatory obstacles that differ in each province and territory. Rates of return, investor appeal, exit routes, and operating costs associated with CEDIFs and other equity investments also present practical obstacles that must be addressed.

Tax Credits and other Incentives

Governments across North America and around the world have come to recognize the value of investments in CED initiatives. They have also come to realize that these investments require encouragement through incentives. One avenue for doing this is through tax credits. Other incentives are possible, including tax deductions, investment guarantees, foreign investment allowances, and rate of return guarantees. While tax deductions and investment guarantees have been employed in limited circumstances, foreign investment allowances and rate of return guarantees have never before been proposed for CED investments.

Conclusions

CCEDNet should undertake an initiative to move gradually toward the introduction of a national equity investment strategy, culminating in the creation of a widely-available CED equity investment fund. The process for achieving this goal has five essential steps.

1. Establishing Protocols for Equity Investments in CED that could be based around the following principles:

- Equity investments for CED purposes must demonstrate tangible benefits to the broader community
- Ventures seeking equity capital must be based on sound business models, and have a reasonable chance of long-term viability
- Ventures seeking equity capital must have a reasonable chance of generating a rate of return sufficient to attract investors' interest
- Ventures seeking equity capital must be receptive to outside technical assistance and advice
- Ventures seeking equity capital through a CED program should demonstrate that they have been unable to acquire necessary capital from more conventional sources

2. Creating an Interprovincial Dialogue on Equity Investing for CED

To date, equity investment programs for CED in Canada have been coordinated at the provincial level, and have been largely based on the use of provincial tax credits. The development of a national strategy or program will therefore require close coordination between provincial interests. Although a federal program may be a possibility down the road, it will be easier in the short term to work within the existing framework, rather than attempting to create a new one.

3. Identifying Target Groups

A number of problems were outlined relating to the distribution of equity financing. As a result, it may be worthwhile to consider the establishment of a range of specialized national CEDIFs targeting disadvantaged or disenfranchised groups within the larger population.

4. A Regional Pilot Project

The use of an investment pool or fund seems the most viable option for a successful equity investment strategy. It provides economies of scale by investing in multiple projects, can be marketed to a wider variety of investors, allows for greater discretion in selecting target investments, and provides some legitimate possibility of exit routes for investors.

Rather than establishing a national pool immediately, however, it will be important to demonstrate the viability of such an approach to equity investing for CED. The development of a smaller-scale, regional pool as a demonstration or pilot project allows fine-tuning of protocols and activities, and can help to leverage the buy-in of more reluctant partners.

5. A National Program

The final step is to create a national model based on the results of earlier research and of the regional pilot project. At the heart of the national program would be the creation of a

CEDIF, a targeted investment pool designed to enhance local CED initiatives.

In the end, such a venture represents a significant undertaking, and has major ramifications for the organization assuming the lead role. However, it seems likely that if the necessary research can be completed, and the appropriate relationships can be built, significant new resources will be available to disenfranchised groups and communities across Canada. Although the task is daunting, the opportunity exists to make literally millions of new dollars available for renewing and revitalizing communities across Canada.

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1.0 Introduction

1.1 Equity Financing and CCEDNet

At its National Policy Forum in Vancouver from 22-24 March, 2001, the Canadian Community Economic Development Network (CCEDNet) addressed a variety of technical and policy concerns related to the active practice of Community Economic Development (CED) in Canada. These discussions led to a series of five policy recommendations, essentially research agendas to explore methods of enhancing the delivery and efficacy of CED work in Canada. Recommendation 5, perhaps the most controversial of the Forum's recommendations, related to the thorny question of equity financing for CED initiatives. Under this recommendation, CCEDNet was tasked with carrying out "the necessary policy research, looking especially at the Nova Scotia and New Hampshire models, [in order to] institute a new tax incentive program that will encourage individual and/or private sector provision of equity capital to CED projects."[1]

In order to fully address this recommendation, CCEDNet recognized a need to prepare a detailed background paper, both as a means of education for CED practitioners about the nature and role of equity, and to review many of the programs and practices related to equity financing and CED that have emerged in recent years. The results of this broad examination will then be used to create a clearer understanding of equity and CED for CCEDNet's memberships, and ensure a common foundation for future discussions about the role of equity financing in the Canadian CED context.

From CCEDNet's perspective, the ultimate objective of linking equity to CED initiatives is to "engage in a comprehensive strategy of local empowerment and revitalization" by facilitating "long-term investments in productive pieces of the local economy: in new or expanded businesses, commercial property development, or affordable housing."[2] Such approaches to the use of equity are relatively new. Indeed, much of the vocabulary and practice of equity financing is intrinsically linked to the traditional practice of economics; its interface with community economic development is largely uncharted territory. As a result, much of the research and information related to equity financing is traditional in its formulation. Indeed, the very vocabulary of equity financing is that of traditional economics, and the transition to its use as a tool for local empowerment and community

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[1] "CCEDNet National Policy Forum," *Making Waves*, Vol. 12 No. 2, p. 10.
[2] "CCEDNet National Policy Forum," p. 10.

revitalization is problematic. While there is little doubt that equity financing provides solid, tangible benefit and opportunity at the community level, many CED practitioners may have only a passing familiarity with the economic nuances of investment analysis. Similarly, the few existing programs using equity to support CED initiatives are so new that they have not yet fully clarified the range of issues raised by the use of equity.

The overall goal of this discussion paper, therefore, is to bring some initial clarification to the question of equity financing in a CED context. This effort will assist in the development of a clearer concept of equity, and to flag a number of issues – both positive and negative – that must be considered in the development of any future initiatives to utilize equity for CED purposes.

1.2 Project Overview

The National Policy Forum essentially left CCEDNet with two principle tasks related to the equity question. First, there was a need to create a discussion document that played an educational role on the equity question, providing CCEDNet members and partners with a common foundation of information on which to base future discussions. Second, in framing this background discussion there was clearly an opportunity to provide CCEDNet with some preliminary recommendations for future action.

To this end, CCEDNet directed that the equity financing discussion paper should attempt to examine seven key areas:

1) The problem of equity in CED initiatives and in disenfranchised communities;
2) The differentiation between equity and debt financing of projects;
3) The concept of a tax credit, including definitions and related issues;
4) Descriptions of the ways that a tax credit program can be used to increase equity and also to support and build other CED initiatives;
5) An evaluation and critique of existing tax credit models including the ones in Nova Scotia, New Hampshire, the United States and the United Kingdom, as well as those associated with labour-sponsored investment funds and cooperatives in Quebec;
6) An investigation of other government programs that enhance equity, such as the ones administered by Agriculture Canada;
7) A proposal of how a Canadian model might be structured based on the needs of the Canadian CED community and the most advantageous elements of the models investigated in this research.

A period of six weeks was available to conduct this research and prepare the discussion paper.

1.3 Project Methodology

Given the broad scope of the equity financing and CED project, work to accomplish the project goals fell into several broad categories:

Literature Review: An extensive review of both print and Internet sources was conducted. This review included an examination of existing equity programs for CED (such as those in Nova Scotia and New Hampshire), as well as of the limited quantity of theoretical and analytical material available concerning such initiatives. Extensive research was also conducted using standard economics works and resources, to better define the nature of equity, and other types of financing mechanisms. The range of materials consulted was large and diverse; although a complete bibliography has not been appended, key materials or controversial concepts in this discussion paper are referenced by footnotes to assist future researchers.

Personal Interviews: Interviews were conducted, by telephone and in person, with key players in both the CED and equity financing fields. Individuals in the United States, Europe and Canada (including CCEDNet members) were included in this process. In some instances, community members involved in CED projects that had received equity financing under various programs were also consulted, to clarify the impact of the initiatives from a user's perspective.

Site Visits: A limited number of site visits were conducted, providing an opportunity to view some equity-financed CED initiatives first-hand. These included:

- The West Nova Investment Co-operative Ltd. (Meteghan, Nova Scotia)
- U.J. Leblanc Investment Co-operative (Arichat, Nova Scotia)
- Isle Madame Investment Co-operative (Arichat, Nova Scotia)
- Technopolis (Oulu, Finland)

In addition, project staff visited with an organization in Halifax, Nova Scotia attempting to establish an organic farmers' investment cooperative.

2.0 Equity and Community Economic Development

2.1 A Definition of Equity

All financial transactions, from a strictly economic perspective, deal with the process of transferring financial capital (i.e. money or purchasing power) from one individual, business or institution to another. This can be done through several mechanisms (termed "asset classes", as will be outlined in Section 3 of this discussion paper), but one of the principal avenues for transferring this capital is through "equity". At its most basic, equity represents a capital transaction in which an ownership stake is exchanged for capital. The simplest example is a case in which one individual invests cash in another's business venture, and in return for that investment receives a portion of the business venture. This portion (or "share") represents equity that the investor now owns. From this simple notion, significant institutions have emerged, including stock markets, where "shares" are exchanged for "capital" invested by millions of investors. Each of these "share-holders" can be said to own equity in the companies for which they own shares.

In general, equity investments are riskier than other kinds of investments. Putting money in a savings account, or even under a mattress, entails little risk. Equity investments are riskier, however, because the company invested in may fail – that is, it may lose money or even go bankrupt. If this happens, the shareholder may lose the entirety of his or her investment. As a result, equity investments generally seek to offset a higher degree of risk by offering the investor a higher "return on investment". In other words, equity investors are generally encouraged to invest in a business venture because (should the venture be successful), the investment will earn more money than it would under the mattress or in a savings account. The goal of traditional equity investment, then, is twofold. For the investor, it is a way of increasing personal wealth. For the business venture, it is a way to acquire capital to start or expand a business.

This second role is the one that is most directly linked to economic development strategies. Practitioners of all types of economic development (e.g. industrial development, international development, community economic development) seek ways to finance business start-ups and expansions. Though motivations and practices may differ, economic developers as a group seek to increase economic well-being and opportunity, and making capital available to business ventures is one way to do this.

2.2 Problems with Equity

Although millions of equity transactions occur everyday, the overall pattern of such transactions poses problems from a CED perspective. The first of these problems is that equity investment has not been evenly distributed within the population. For a wide variety or reasons – some hegemonic, some ethnocentric, some patriarchal – investment has tended to gravitate towards a narrow group within the larger population. First, it has tended to focus on opportunities within industrial nations. In 1996, the United Nations

Development Program Office of Development Studies suggested that "only about 25 developing countries have so far achieved a credit-risk rating of 'near investment grade'. The majority of developing countries is not yet able to inspire sufficient confidence among investors."[3]

Second, equity investment patterns have traditionally followed long-established gender biases; equity appears to be much more readily available to men than it is to women. Thanh-Dam Truong has argued that the "male-centred perspective on economy and society… has become embedded in the patterns of reasoning and policy debates in development, and by extension [has] reinforced gender differences in the development process…"[4] In other words, the male-dominated business culture that has historically made use of equity investments continues to follow ingrained behavioural patterns that deny the benefits of such investments to women entrepreneurs.

Third, equity investment patterns display ethnocentric biases, denying equal access to equity to members of different cultural or racial groups. As an example, recent work by Industry Canada has shown that aboriginal businesses in Canada show solid growth potential: 36% showed increased sales in the 1995-1996 period, while 60% expected to grow in the following two years. However, surveys showed that the single largest hurdle facing those aboriginal businesses expecting growth was "inadequate financing."[5]

The tendency of equity investments to move in patterns that deny capital to those outside of the established power structure is not the only weakness of equity from a CED perspective. As outlined above, equity investments are attractive to the individual investor because they offer the potential of a higher rate of return than other kinds of investments. Indeed, equity investors are deliberately seeking these higher rates of return, carrying out what traditional economic theory calls "rational" behaviour. If all equity investments generated an equal return on investment, this would not be a problem. In the real world however, rates of return vary dramatically. Some businesses fail altogether, while successful businesses can vary form the mom-and-pop corner milk store to multinational giants like Microsoft. Following "rational" behaviour, equity investors will seek to make investments in those companies likely to generate the largest returns on investment. Over time, this has a tendency to focus investments and capital in certain areas, and to draw it away from others. In recent years, for example, capital has flowed away from traditional industrial centres like Flint, Michigan or Sydney, Nova Scotia and towards new high tech business centres like Silicon Valley, California or Ottawa, Ontario.

In Canada, this general trend has accelerated in recent years, with capital (money) flowing out of rural Canada, and out of traditional regional centres, into central and urban

[3] Hugh Peynman, *Money Matters: Private Finance for Sustainable Human Development* (New York, 1996), p. 2.
[4] Thanh-Dam Truong, "A Feminist Perspective on the Asian Miracle and Crisis: Enlarging the Conceptual Map of Human Development," *Journal of Human Development*, February 2000, p. 160.
[5] David Caldwell and Pamela Hunt, *Aboriginal Businesses: Characteristics and Strategies for Growth* (Ottawa, 1998), p. 5.

areas. In part, this is because, on average, the equity investments in these centres have a higher chance of being highly profitable than those in smaller centres. This encourages investors to look away from smaller centres when they place equity investments.

However, in recent years, a new phenomenon has greatly exacerbated this situation. Over the past 20 years, Canadians have increasingly looked to mutual funds and Registered Retirement Savings Plans (RRSPs) as their means of making equity investments. In the case of RRSPs, government tax incentives have encouraged this trend. Unfortunately, most of the major mutual funds and RRSPs are managed by large financial institutions or chartered banks. These institutions, headquartered in major urban centres, are most likely to be aware of investment opportunities in those same major urban centres, and therefore rarely pursue investment opportunities in smaller areas. Furthermore, because of the size of the funds they administer (often billions of dollars), they must focus on large investments. A single $500 million investment in the stock market is easier and less expensive to manage than five hundred $1 million investments in small communities.

This trend is doubly crippling to small communities. Not only do the major institutional investors tend not to invest in small communities, they actually draw money out of those communities. An individual investor in a small community may have a few thousand dollars to invest. In and of itself, this amount is not usually significant enough to finance a business. As a result, the investor - seeking a reasonable rate of return - will invest this amount in an RRSP or mutual fund, perhaps offered by the local bank branch. The impact of this decision, however, is that the dollars flow out of the small community and into the major centres.

In the end, CED practitioners observe two difficulties with equity financing:

1. The capital used to purchase equity tends not to be offered to entrepreneurs or opportunities outside the traditional power structure;
2. The capital used to purchase equity tends to flow away from small, local uses towards larger, institutional uses.

Thus, the entrepreneurs and opportunity-builders within these population groups and communities are said to be disenfranchised, or disempowered. At a basic level, they lack the investment necessary to build their businesses.

2.3 The Need for Equity

Although it is clear that equity financing flows do not benefit all groups and communities equally, it should also be clear that equity financing can have a tremendously positive impact on individuals and communities. Equity financing can make significant amounts of money available to new business initiatives, whether they be individually-owned, owned in partnerships, or owned as cooperatives. Often, equity financing is a way of acquiring start-up dollars when larger institutional lenders like banks will not provide it.

Indeed, the much-vaunted concept of venture capital is really just equity financing in a high-stakes (high risk/high return) environment.

Equity investments have two distinct advantages from a CED perspective, however. First, they provide an avenue for very early funding of new ventures and initiatives. In a business start-up, loans or credit (known in economics as "debt") may be very difficult to acquire. An entrepreneur may have a great business idea, great business skills and a great business plan, but with no money and no securable assets, few lenders will consider making a loan. An equity investment can either provide enough capital to start the business without a loan, or provide enough capital for the business to acquire property or assets that could serve as collateral for a loan. As a result, equity investment makes start-ups possible in situations where credit alone cannot. For more on the difference between equity and debt, see section three.

The second advantage of equity from a CED perspective is that it can help to keep capital (money) in smaller communities. This seems to contradict the concept of capital outflows from smaller communities outlined above, but it should be made clear that if equity investment opportunities can be found in smaller or disenfranchised communities, they are a way of retaining local wealth, and putting it back to work for the benefit of the community. The trick for a CED practitioner is to find ways to do this. Indeed, many provinces and US states have begun to develop CED programs to do just this. Often referred to as Community Economic Development Investment Funds (CEDIFs), these programs are designed to facilitate millions of dollars of equity investments in disenfranchised communities for CED purposes.

A CED Investment Fund or CEDIF is a pool of money raised by individuals, groups and businesses for investment in a community. The funds are typically invested in businesses that traditionally have difficulty in attracting equity. In addition, funds are often invested in co-operatives, community enterprises and community infrastructure including housing, and day care.

CED Investment Funds operate in various parts of Canada, the United States, and Europe. Manitoba, Nova Scotia, North West Territories and Saskatchewan have investment funds that focus primarily on the business components of CED. In the United States, a low-income housing tax credit applies to all states, while New Hampshire has a very comprehensive CEDIF that focuses primarily on a community assets approach to projects.

The bottom line is that although traditional economic relationships and large institutional players have prevented the benefits of equity from accruing to all entrepreneurs and communities equally, this does not suggest that equity is flawed. Rather, equity can be a powerful tool for local empowerment and economic growth, building opportunity and community capacity. To achieve this however, CED practitioners must utilize tools and models (like CEDIFs) that bypass the inherent weaknesses and faults of the established financial power structure, in order to facilitate the flow of capital from those who hold it, to those who can make use of it at the community level.

Figure A
Examples of CED Investment Funds

Location	CED Fund	Purpose	Investors	Guarantees
Saskatchewan	Community Bonds	Business development & financing within rural and urban Saskatchewan communities	Residents and Corporations with a head office in the province	100% government guarantee on principal
Manitoba	Grow Bonds	Business development & financing in rural areas of Manitoba	Residents & incorporated Manitoba organizations	100% Government guarantee on principal plus eligibility under self-directed RRSP
Nova Scotia	Community Investment Fund	Business development and financing in areas of high unemployment	Residents of Nova Scotia only	Government guarantees: 30% tax credit 20% guarantee RRSP eligibility
New Hampshire, USA	Community Development Finance Authority	Business & Low Income Housing Development	Residents of New Hampshire only	Tax Credit of 75% on principal

2.4 Capital and Ownership

In some circles, it has been suggested that equity investments may run counter to community interests, by entrenching existing economic structures. This is because the investor represents a player in a community who already has wealth (i.e. enough money that there are funds left over to invest). Since equity investment is designed to produce a rate of return, this person generates more wealth. Arguably, this entrenches the person's dominant position within the socioeconomic hierarchy.

However, this perspective misses several key points. Even though the investor seeks a return on investment, this can only happen if the venture invested in is successful, and if it is successful, then others are also increasing their wealth and economic wellbeing. In essence, the wealth of an individual is thereby used to generate wealth for the entire community.

Additionally, the success of a new venture introduces additional wealth to the entire community through the “multiplier effect”. In other words, the introduction of a successful business into a community has benefits that accrue beyond the individuals directly involved in that business and into the larger community.

Finally, as equity investment opportunities multiply (be they CEDIFs or RRSPs), the amount of money needed to become an equity investor is low. Since equity represents ownership, equity investing by community members fulfills one of the great theoretical and political aims of social democracy – workers are given the opportunity to own the means of production.

3.0 Equity, Debt and Derivatives: Types of Financing

3.1 Classifications of Capital

In modern economic theory, capital (or money) can be made available in three distinct fashions, known as “asset classes”. Asset classes of all types are designed to facilitate the transfer of capital from one individual or enterprise to another individual or enterprise. Each asset class has distinct and formal legal rights and norms attached to it, in order to simplify the transaction process, and protect the interests of those involved. The first asset class, “equity”, is the subject of this discussion paper. The second asset class is known as “fixed-income” or “debt”, while the third asset class is referred to as “special equity instruments” or “derivatives”.

3.2 Equity

The asset class of equity has been defined above in Section 2.1. To review, equity represents a capital transaction in which an ownership stake is exchanged for capital. The simplest example is a case in which one individual invests cash in another’s business venture, and in return for that investment receives a portion of the business venture. This portion (or “share”) represents equity that the investor now owns. From this simple notion, significant institutions have emerged, including stock markets, where “shares” are exchanged for “capital” invested by millions of investors. Each of these “share-holders” can be said to own equity in the companies for which they own shares.

Ownership of equity is considered to be more risky than investments made through fixed-income or debt methods. This is because, in the event of a bankruptcy, the equity holders (or shareholders) are the last parties entitled to any of the venture’s assets.

3.3 Debt

The second asset class is known as fixed-income, but is most commonly referred to as debt. This asset class can take a wide range of forms, but is based upon the fundamental principle that an investor who makes capital available to a business receives a series of fixed payments in return. The individual or enterprise who receives the funds agrees in return to make specific payments at predetermined times.

Much of the “credit” commonly made available to individuals or companies is made available in this form. Sources of fixed-income or debt financing that are widely available and widely familiar include credit cards, bank loans and lines of credit. In practice, however, there is an extremely wide range of debt financing mechanisms available. The following chart outlines the most common.

Figure B
Common Forms of Debt Financing

Marketable Bonds are fixed-income obligations that pay out a specified interest rate and mature on a specific date. Although they can traded in the secondary market (i.e they can be exchanged or traded between parties), they are generally used only by large institutions. This is due to their size. For example, in 1991, the Government of Canada issued a $700 million marketable bond.

Provincial Bonds are a provincial version of marketable bonds, and are issued to cover provincial deficits. The bond is guaranteed by a province's ability to raise taxes.

Municipal Bonds are a municipal version of marketable bonds. They generally have portions of the bond maturing over the lifetime of the bond, a structure also referred to as a serial bond.

Corporate Bonds are a version of marketable bonds issued by large corporations such as Bell Canada to raise capital. Each corporate bond is rated (which determines the interstate paid to the investor) and includes and indenture (which acts as a list of the company's legal obligations).

Mortgage Bonds are legal agreements that pledge land or buildings as security for a loan. During the term of the arrangement, the lender is entitled to take ownership of the property if the borrower fails to pay interest or principal when it is due.

Collateral Trust Bonds are secured by a pledge of financial capital (also known as "securities"). These are often used by holding companies who own no physical assets, but have many shares (or equity holdings) in other companies.

Equipment Trust Certificates are a variation of mortgage or collateral trust bonds where equipment is used to secure the loan, rather than land, buildings or securities.

Foreign Bonds are international bonds denominated in the currency of the country where they are issued. For example, to raise American dollars, the Government of Canada issues the Yankee Bond, which is sold only in the United States for American dollars.

Convertible Bonds have the interest and principal characteristics of other bonds, but the bondholder has the option to turn the bond back in to the issuing firm in exchange for common stock (i.e. equity).

Income or ***Residual Bonds*** stipulate interest payment schedules, but this interest is only paid if the issuers earn the necessary income to make the payments by the stipulated dates. If the company does not earn the required amount, it does not make the interest payment but also is not required to declare bankruptcy. Rather, the interest payment is considered in arrears, and added to future payments.

Zero Coupon or ***Strip Bonds*** do not pay interest. Instead, they are sold at a discount and pay one lump sum at the time of maturity.

Debentures are unsecured bonds. They represent direct obligations of the issuing company, but do not have specific claim or assignment on assets. In the event of bankruptcy, the debenture-holder is paid after secured debt and current liability holders.

Secured Debentures are a variation of standard debentures where assets are used to secure a portion of the loan.

Subordinate Debentures are a variation of standard debentures. In the event of bankruptcy, the subordinate debenture-holder is paid after secured debt, current liability and standard debenture holders.

Treasury Bills are short-term obligations issued and guaranteed by the federal government. They do not pay interest, but are instead sold at a discounted rate and redeemed for full value when they mature. This maturity is reached in a short time frame, generally less than one year.

Preferred Stock has some equity characteristics, but is technically classified as a fixed-income or debt instrument. This is because preferred stock includes an annual dividend payment, stipulated as either a coupon (5% of face value) or stated as a dollar amount. This differs from bonds because the payment is a dividend and therefore not legally binding. For each period, a firm's Board of Directors must vote to pay the dividend.

While many of these fixed-income instruments are complicated in design and require detailed economic knowledge to decipher, most individuals are familiar with the way in which these instruments are made available in everyday life. All mortgages, for example, are actually financed through mortgage bonds, although it's not usually expressed this way to the consumer. Similarly, many bank loans or lines of credit are actually just collateral trust bonds or equipment trust certificates repackaged for consumer use.

The fundamental concept behind debt is that an individual with money lends it to another, on the understanding that the funds will be repaid in the future. In the normal course of events, the lender will seek more money in return than was original loaned out (the difference coming, for example, through interest). Additionally, most lenders will seek some kind of security for their loan, some way of recovering their money should the borrower fail to repay the loan. The instruments outlined above are all mechanisms for creating these kinds of relationships.

Debt differs from equity in several ways. First, debt does not represent ownership. An equity investor actually owns a part of the venture in which he or she invests, while a fixed-income or debt investor does not. Second, debt is generally secured by some outside asset (equipment, property, securities, etc.), while equity is not. This latter fact is what make debt investments less risky than equity investments.

It should be pointed out that in some cultures, debt financing is considered immoral or even unlawful. Under the *shari'a* code of Islamic law, for example, debt financing is forbidden. This is because interest – a characteristic common to most debt financing instruments – is essentially a payment made in exchange for the passing of time. From an Islamic viewpoint, however, time belongs to Allah, and should not be "taxed". As a result, banking in Islamic countries functions very differently than in other regions, and is based largely upon models approximating equity investing rather than debt investing.[6]

3.4 Derivatives

The third asset class is called "derivatives", sometimes referred to as special equity instruments. Although there are a variety of forms of derivatives, the only one used to raise financial capital is the warrant.

A warrant is a promise to the warrant-holder that they may purchase equity (common shares) within a specified time period and at a specified price. In Europe, warrants are usually valid only on a specified date, while in North America they are usually valid within a fixed window of time (e.g. during a specified 3-month period). The warrant-holder may use the warrant at that time if it seems financially advantageous. Warrants are considered the most risky of the three investment classes because unless they're redeemed at the specified time and under the specified terms, they have no value and entitle to the warrant-holder to none of a company's assets.

There are several different types of derivates. Listed below are the four different classes:

Options
Options give the buyer the right, but not the obligation, to buy or sell an asset a set price on or before a given date. Investors, not companies, issue options. Buyers of call options bet that a stock will be worth more than the price set by the option (the strike price), plus the price they pay for the option itself. Buyers of put options bet that the stock's price will drop below the price set by the option. An option is part of a class of securities called derivatives, which means these securities derive their value from the worth of an underlying investment.

Futures Contracts
Futures contracts are agreement to buy or sell a set number of shares of a specific stock in a designated future month at a price agreed upon today by the buyer and seller. The contracts themselves are often traded on the futures market. A futures contract differs from an option because an option is the right to buy or sell, while a futures contract is the promise to actually make a transaction. A future is part of a class of securities called derivates, so named because such securities derive their value from the worth of an underlying investment.

[6] For a complete discussion of the origins and implications of the *shari'a*, see Milton Viorst, *In the Shadow of the Prophet: The Struggle for the Soul of Islam* (Toronto, 1998), pp. 141-173.

Rights
Rights are privileges granted shareholders of a corporation to subscribe to shares of a new issue of common stock before it is offered to the public. Such a right, which normally has a life of two to four weeks, is freely transferable and entitles the holder to buy the new common stock below the public offering price. A "rights offering" is an issuance to shareholders that allows them to purchase additional shares, usually at a discount to market price. Holdings of shareholders who do not exercise rights are usually diluted by the new offering. Rights are often transferable, allowing the holder to sell them on the open market to others who may wish to exercise them. Rights offerings are particularly common to closed-end funds, which cannot otherwise issue additional common stock.

Warrants
Warrants are a security entitling the holder to buy a proportionate amount of stock at some specified future date at a specified price, usually one higher than current market price. Warrants are traded as securities whose price reflects the value of the underlying stock. Corporations often bundle warrants with another class of security to enhance the marketability of the other class. Warrants are like call options, but with much longer time spans - sometimes years. Further, warrants are offered by corporations, while exchange-traded call options are not issued by firms.

As indicated above, options and futures are generally not issued by the company receiving the funds, so no equity is raised. Stock bonus plans or stock options for employees generally cost the firm money, as they allow the employee the option to purchase shares in the company for a price less than the market rate. Likewise, rights are generally used by existing shareholders to protect their control (percentage) in the company. As stated above, they are generally issued to existing shareholders. These roles and functions are of little interest in the context of community economic development investments.

3.5 Equity Vs. Debt Investment

In the end there are three fundamental differences between equity and debt. The first basic difference is that equity represents ownership, while debt does not. An entrepreneur or business will have to evaluate options to determine whether giving up a portion of ownership is to its advantage or not. In some instances – such as community-owns businesses or cooperatives, it may make little difference, as the investors may own the venture anyway. In businesses owned by individuals, however, this is an issue worth serious consideration.

The second difference relates to the availability of capital, of money to invest. Debt investment generally requires security; the enterprise must already own property or equipment to be used as security or collateral for a loan. For many businesses, this is problematic. Start-up businesses often have no assets to use in this way. Similarly. knowledge-based businesses or businesses relying artisanal, traditional or craft skills often have no securable assets. From this perspective, equity investment offers a source of capital that would otherwise not be available.

The third difference between equity and debt relates to the second. Because equity is not usually securable, it is considered to be a higher risk investment. Because the risk is higher, the investor will normally expect a higher rate of return. That expected rate of return will vary, but will generally increase as the level of perceived risk increases.

4.0 Tax Credits

4.1 Definition of a Tax Credit

Canada, like most countries, utilizes a financial regime under which income earned by individuals, organizations or corporations is subject to taxation. Taxation is the collection of capital from non-governmental sources for reallocation and redistribution by government.

However, taxation does not take 100% of the funds way from those who are taxed. Each individual or corporate body is left with money that they may choose to use for their own purposes. Occasionally, governments decide to encourage the use of this money for certain purposes. Often, this encouragement is accomplished through a tax credit. At its most basic, a tax credit is essentially an agreement between a government and a taxpayer to reduce the amount of taxes to be paid in exchange for an expenditure or investment in an arena where the government seeks to increase such investment.

A classic example of this practice is the variety of tax credits used to encourage spending on research and development in Ontario, including the Ontario Business Research Institute Tax Credit. Another program, the Ontario Computer Animation and Special Effects Tax Credit, offers a tax credit equal to 15% of a company's labour expenditures related to computer animation and special effects, provided the work is carried out in Ontario. In other words, for every $100 a company spends on employing people in the computer animation field, they are allowed to reduce their overall tax bill by $15.

Tax credits are different from the more taxation tool, the tax deduction. A credit is applied against taxes that are to be paid, while a deduction is used to reduce the total amount of taxable income. This distinction is discussed in greater detail in Section 8.3.2.

On the following chart, a range of tax credits available in each province has been identified. While not exhaustive, those highlighted have the most relevance for CED practitioners. Those credits highlighted in bold are discussed in greater detail in Section 6. Quebec and Nova Scotia do not appear on this list, as they are discussed in greater detail in Section 5.

Figure C
Available Provincial / Territorial Credits

Provincial foreign tax credit and Political Contribution Tax Credit are common to all provinces and territories (except Saskatchewan).

Province / Territory	Tax Credits
Newfoundland and Labrador	• **Direct Equity Tax Credit** • **Venture Capital Tax Credit**
Prince Edward Island	• **Equity Investors Incentive Program**
New Brunswick	• Labour Sponsored Venture Capital Fund Tax Credit • Stock Savings Plan Tax Credit
Ontario	• Property Tax Credit • Sales Tax Credit • Labour-sponsored Investment Fund Tax Credit • Employee Ownership Tax Credit • Home Ownership Savings Plan Tax Credit • Research and Development Tax Credits *Tax Credits for Self-Employed Individuals:* • co-operative education tax credit • graduate transitions tax credit • workplace child care tax credit • workplace accessibility tax credit • educational technology tax credit
Manitoba	• Property Tax Credit • Labour-sponsored Funds Tax Credit • **Equity Tax Credit** • Learning Tax Credit
Saskatchewan	• Labour-sponsored Venture Capital Tax Credit • Post-secondary Graduate Tax Credit
Alberta	• Royalty Tax Rebate
British Columbia	• Sales Tax Credit • Employee Share Ownership Plan Tax Credit • Employee Venture Capital Tax Credit • Venture Capital Tax Credit • Mining Exploration Tax Credit • Logging Tax Credit
Yukon	• **Small Business Investment Tax Credit** • Labour-sponsored Venture Capital Tax Credit • Mineral Exploration Tax Credit • Yukon First Nations Income Tax Credit
Northwest Territories & Nunavut	• Cost-of-living Tax Credit • **Risk Capital Investment Tax Credits**

4.2 Uses of a Tax Credit

Tax credits are useful from a variety of perspectives. For government, it is a way of encouraging investment in a field where government resources may not be sufficient to meet goals and objectives. Thus, the Ontario Computer Animation and Special Effects Tax Credit is used by the Ontario government to spur investment and employment growth in the high tech arena.

For corporations, tax credits may make certain activities affordable. Research and development, for example, is an expensive process. Tax credits offer a company an incentive to carry out this kind of work, by reducing the corporation's tax bill at the end of the year.

For individuals, tax credits are a way of reducing personal income tax costs. Furthermore, since most Canadians pay taxes in advance by way of payroll deductions, tax credits can mean a tax rebate at the end of the year.

In all these instances, however, tax credits are a means for government to reward investors for putting their money to work in specific areas where there is a perceived advantage to the larger community. In the CED context, this has led most recently to the introduction of tax credits for those who make equity investments in Community Economic Development Investment Funds (CEDIFs). The underlying rationale is that while CED is good for the community, government resources alone may be insufficient (or inappropriate) for certain kinds of CED investment. The combination of CEDIFs and tax credits is thus a mechanism to encourage investment in CED by rewarding those who make equity capital available with a tax credit.

It is also important to note that tax credits have a real impact on government revenues and spending. Giving a tax credit to an individual or corporation actually decreases a government's overall revenues by a corresponding amount. As a result, governments only provide these credits in limited instances.

5.0 Overview of Major CED Equity Tax Credit Programs

5.1 Nova Scotia

The Province of Nova Scotia's Community Economic Development Investment Funds (CEDIF) Program was established to encourage Nova Scotia communities to invest in themselves and determine their own futures. In order to establish a program that would create incentives for individuals to invest in their communities and business that are locally owned and controlled, amendments to the Equity Tax Credit Act and the Nova Scotia Securities Commission were needed.

In 1993, the government established an Equity Tax Credit program that allows for provincial tax credits of 30% to residents that invest in Nova Scotia small businesses. The credit allows equity investment in corporations, co-operatives and community economic development initiatives, with the only stipulation being that investments in corporations are only eligible in newly issued common voting shares without par value. Thus, the program provides an avenue for individuals and community groups to raise capital for local investment purposes.

After considerable public consultation, the provincial Equity Tax Credit was revised in 1995. The reworked program is designed to help new and existing small business capitalize their ventures through the provision of a personal tax credit to investors. The Credit is calculated at 30% of the investment made with an annual maximum credit of $9,000 on an investment of $30,000. This investment can be made at any time during the year in which a company has an active registration, or within 60 days after December 31 (as with any other RRSP-eligible contribution). The Credit is provided through exiting income tax mechanisms, that is, through filings of personal income taxes for the year. Credit balances that exceed provincial income taxes payable can be carried back three years or forwarded seven years.

Eligibility criteria for participating investments include:

1. At least 25% of wages and salaries of the company are paid in Nova Scotia; and
2. Business assets or revenues cannot exceed $25 million, including assets and revenues of affiliated corporations or associations; or
3. 90% of the fair market value of the property of the corporation is used in an active business or invested into a business that meets the criteria.

CEDIFs were developed as an enhancement to the tax program. In addition to the 30% tax credit, investments in CEDIF corporations and co-operatives are partially guaranteed by the Province, are pre-approved as holdings in self-directed RRSPs, and can attract investment through community solicitation. The investments also assist in the development of local businesses within the community.

By offering an investment instrument that is eligible for pre-approved holding of self-directed RRSP under the Federal Income Tax Regulations, and by providing a 20% provincial investment guarantee for the 4 years following the investment, Nova Scotia

CEDIFs gain access to a wider investor pool at the community level. The CEDIFs are also supported by economic and business development services across the province, both in terms of establishing the CEDIF structure and in providing assistance with business development. CEDIFs also receive the same benefits that companies or co-operatives obtain by registration under the tax credit program.

Although fairly simple in nature, the process needed to establish a CEDIF requires significant effort on the part of organizations and individuals seeking to register a CEDIF corporation or co-operative. The first step involves defining the community in which the CEDIF will operate. Flexibility in preparation of a community economic development plan allows for local factors and determinants to guide the CED process. Generally, the following activities comprise the development of a community economic development plan: research and analysis of economic factors, interviews with representatives of major employers, business and community organizations, economic sectors and government agencies, public meetings, consensus building, and writing the strategy report.

The second step in creating the CEDIF involves making an offering of shares to the public. This part of the CEDIF is completed under strict conditions. A complete and formal legal document, commonly known as a Simplified Offering Document (SOD), must be drafted. The SOD outlines the offering of shares in the CEDIF to prospective investors. More specifically, the SOD outlines *"what the investor is buying with his or her investment funds. It details who is making the shares or units available, what the total value of the offering is, and how the funds are to be invested."*[7] The provincial government's technical guidebook to CEDIFs suggests that legal advice should be obtained prior to submitting a completed Simplified Offering Document. The guide further suggests that multiple submissions to the Province's Securities Commission will likely be required before the Corporation or Co-operative receives the "letter of non-objection" that is required prior to solicitation of investment funds.

The third component involves establishing the Community Economic Development Corporation or Co-operative that will make the specified issue of shares. Once formed, the Corporation or Co-operative is required to submit a completed Simplified Offering Document and an Equity Tax Credit application form, with a number of required attachments including:

- Financial statements of the corporation for the preceding taxation year
- Corporation Constitution or Articles of Association of the organization
- A copy of the community economic development plan
- Any other relevant information that might be prescribed by regulation or required to determine compliance with the Securities Act and regulations including a list of proposed investors, a business plan and financial statements.

A point of consideration is that no individual can control more than 20% of the corporation. Investors that seek to qualify for the provincial tax credit and registered

[7] *Guide to Community Economic Development Investment Funds*, Province of Nova Scotia, page 1.11

retirement self-directed option must also be residents of the Province (i.e. at least 12 months).

The following table presents an overview of current investments in CEDIFs in Nova Scotia.

Figure D
Sample Nova Scotia CEDIFs

CEDIF	Local Capital Invested	Use of Funds
Isle Madame Investment Co-operative Ltd.	$150,000	Blind pool of capital for investment in Isle Madame small businesses
West Nova Investment Co-operative Ltd.	$300,000	Flow through investment into one key business opportunity
Hants Ventures Inc.	$400,000 (47 investors)	Direct investment in or operation of a business key to the economy of the community
BC Investment Co-operative Ltd.	$1,200,000	Blind pool of capital for investment in Cape Breton small businesses

Nova Scotians who are familiar with the CEDIFs have mixed feelings about the program to date. Interviews conducted in preparing this discussion paper suggest that considerable awareness exists relative to the use of CEDIFs in capitalizing local business ventures.

For example, organic farmers in rural Nova Scotia seeking to establish a retail/wholesale outlet for their goods in Halifax using the CEDIF program to capitalize their project indicated that the level of awareness is strong among non-financial experts in the use of CEDIFs in Nova Scotia. However, much of the public discussion still involves the relative returns that investors can reasonably expect from their CEDIF investment. Exit strategies are also an important issue that has not been completely addressed. Issues of fund accountability also need further discussion and evaluation.

In Nova Scotia, 16 CEDIFs have or are in the process of receiving provincial approval for the issuing of shares to local investors. Each entity has been created based on local economic and social dynamics, with particular efforts aimed at building on local business strengths and entrepreneurial spirit. While some have been moderately successful, comments from community practitioners and interested parties seem to suggest that considerable efforts must be attached to making strong business cases for local investors to contribute their precious equity or RRSP dollars to local initiatives.

Technical assistance and support is seen as a key to the establishment of not only successful CEDIFs in Nova Scotia, but also successful business ventures that offer relatively secure investment opportunities to local investors. Interviews with past and current CEDIF applicants indicate the need to develop a solid business concept, including sound financial and business plans to support capitalization efforts.

Furthermore, many of the most successful Nova Scotia CEDIFs have offered investors more than just a strong investment opportunity. For example, the establishment of the West Nova Investment Co-operative in Digby County offered an opportunity for local small woodlot owners and independent silviculture contractors to increase their economic participation beyond the harvesting of forest resources by investing in the creation of a community sawmill. In essence, the investment also guaranteed the investors a market for their product. This opportunity to invest and help capitalize a project that would also provide opportunities for greater returns on their raw commodities enhanced the ability to raise local capital for the CEDIF

5.2 New Hampshire

New Hampshire's Community Development Investment Program (CDIP) is the major funding program for community development projects in the state. While the program has proven to be a major source of support for affordable housing and economic development, corporate donations eligible for the tax credits are limited to $5 million yearly. Competition for funds under the program is highly competitive.

Administered by the Community Development Finance Authority (CDFA), the CDIP enables New Hampshire's businesses to donate funds or property, in lump sum payments or pledged over a predetermined period, to fund economic development and housing projects throughout the state. Contributions made by businesses entitle them to a 75% state tax credit when the tax returns are filed with the New Hampshire Department of Revenue Administration. A donor who donates $10,000 to CDFA on behalf of an approved project will therefore receive a tax credit for $7,500. The credit may be applied directly on a dollar for dollar basis against the following state business taxes: business profits taxes, insurance premium taxes, and/or business enterprise taxes.

The CDFA was established by legislation in 1983 to address the issues of affordable housing and economic opportunity for low and moderate-income residents of New Hampshire. While the CDFA is committed to providing core operational support in certain cases, the Authority is more oriented to specific, defined projects that can be accomplished within a specific period of time. CDFA funding cannot be used to capitalize endowment programs, replace funding which should be a public responsibility; or fund projects that can attract and support private financing. Legislation restricts the CDFA to providing financial or technical support to:

- Non-profit community development organizations (organizations whose central purpose is housing, community, or economic development);
- Employee, housing or consumer cooperatives;
- Certain municipal or public entities.

CDFA seeks to identify and support innovative projects that show a high degree of community support, that build partnerships, and that leverage other funds.

The new tax credit of up to $5 million per year (previously, CDFA was limited to $2 million per state fiscal year) took effect on July 1, 1999. The annual limit for tax credits that any contributor can use was also increased from $200,000 to $1 million. These changes allowed CDFA to accept new projects for support through the tax credit program.

During 1999, CDFA approved 21 new tax credit projects through CDIP. CDFA issued $1.5 million in tax credits on $2.0 million in donations under the previous tax credit legislation regime. Individual donations came from 106 businesses across New Hampshire and ranged in size from $110 to $202,228. Tax credit approvals are based on:

- Applicability of the request to the enabling legislation;
- The organizational and financial strength of the project sponsor application;
- The quantifiable benefits to low-to-moderate income citizens;
- Community or regional project support;
- The presence of other funding partners (i.e. the leveraging of other money); and
- The availability of CDFA resources.

Pre-approved projects under the new authority as of February 1999 totaled 21 in 1999. Taking into account the CDFA's unique ability to approve multi-year projects, approved funding totaled $15.7 million for new projects over the 1999-2005 period.

CDFA charges the nonprofit project sponsor a fee, typically 20% of the award amount, for participation in the CDIP. The fees are used to support other CDFA community development initiatives and to cover CDFA's operating costs.

It is clear that the New Hampshire model offers some excellent support for local CED initiatives within the state. However, it is equally clear that the New Hampshire model is not truly an equity model. Although New Hampshire companies donate significant and tangible goods for community use, they receive no equity in return, only a tax credit. In other words, companies that use the program have no ownership stake or interest in the CED investments that occur. Instead, they are making donations, for which they receive tax considerations. This is not dissimilar from other (admittedly more limited) programs in Canada, particularly in relation to estate planning.

5.3 New Market Initiatives

On 25 July, 1999 the United States House of Representatives passed the New Markets Community Renewal Act, by a margin of 394 to 27. The Act, usually referred to as the New Market Initiatives, was put forward by the Clinton Administration as mechanism for promoting economic development in America's disenfranchised regions and communities. The Initiatives contain a number of specific development tools, including New Market Tax Credits (NMTC) and, following a decision by the Senate on 26 July, a New Markets Venture Capital Program (NMVC).

The NMTC provides investors with a 30% tax credit for investing in qualifying community development entities in economically distressed urban and rural areas. The NMVC made a number of resources available to new businesses, including US$20 million in grants for capacity-building technical assistance to strengthen the community development venture capital industry (essentially, CEDIFs). The NMVC also provided US$100 million for in matching financing for community development investment funds, plus US$30 million in grants for portfolio firms. These funds are administered and delivered by the federal Small Business Administration (SBA).

Although the New Market Initiatives are too new to assess their overall effectiveness, enthusiastic reports from the Small Business Administration suggest that early signs are positive. The Rhode Island District Office of the SBA, for example, has reported setting records for both the number and volumes of business loans to African-Americans, Hispanic-Americans, Native Americans, women and veterans.

The program does have its opponents, however. Although passing by a wide majority in Congress, the New Market Initiatives were competing with a Republican-backed initiative known as the American Community Renewal Act. This latter act focused on tax cuts, methods to promote savings and home ownership, and the use of faith-based organizations to deliver social assistance. These same issues have been central to President George W. Bush's policy position. It remains to be seen whether the new administration will weaken the New Markets Initiatives to pursue this alternate agenda.

5.4 Europe

5.4.1 United Kingdom

In March of 2001, the government of the United Kingdom launched a major public consultation process examining the question of tax credits for private investment in disadvantaged communities. The results of this consultation were unveiled in July of 2001, and contained five major recommendations. These were:

1. The creation of a community investment tax credit, with both equity and debt investments eligible. Legislation to this effect is expected in 2002, although no details have yet been announced.
2. The creation of a community development venture fund, with the government providing matching funds of up to £20 million.

3. An investigation into banking practice. The British Bankers' Association and the National Treasury are exploring avenues to make lending activities in disadvantaged communities more transparent.
4. The provision of greater latitude for investment in community development initiatives. To this end, the Charity Commission intends to build community capacity and expertise in the area of community development finance.
5. Increased support for Community Development Finance Institutions (CDFIs). Similar to Canadian CEDIFs, these CDFIs will now receive assistance in accessing financing, proactive "champions" within the government bureaucracy to promote their needs and agendas, and as much as £96 million in additional funding over the next four years.

In many ways, the program outlined in the United Kingdom will be similar to that currently in place in Nova Scotia. However, the level of government support and the scope of available funds are significantly more substantial. A few millions have been invested in Nova Scotia, with lukewarm government support, but more than $200 million will be invested in the UK, with cabinet-level leadership involved. While it remains to be seen whether the program is successful at the community level, it appears to be off to a solid start.

5.4.2 Finland

For many years, Finland operated a variety of tax credit programs to encourage equity investments in local businesses. However, with the enormous success of Finnish high tech companies, led by wireless communications giant Nokia, Finnish communities soon found themselves at the heart of the global high tech boom, with massive quantities of investment capital flowing into the country.

Although the high tech sector has suffered in recent months, equity investment capital continues to flow into Finland, where new ventures are multiplying rapidly. In order to facilitate these massive investments, and to ensure that they are spread throughout the country, the Finnish government established a number of centers of excellence, each called a "polis".

The most successful of these is Technopolis, located in the remote northern town of Oulu. With coordination from the University of Oulu and the participation of established businesses, Technopolis created a centralized administrative structure, and issued shares on the Helsinki Stock Exchange. This approach allowed millions of dollars in equity financing to be raised from traditional investors for use in a disenfranchised region. A significant success, Technopolis has helped Oulu become a major centre of community-directed business and employment growth, and has acted as a launchpad for literally dozens of new businesses in Finnish north. Wired Magazine recently ranked Oulu as the "6th Smartest City" in the world.

The success has not come without some drawbacks, however. While the approach has created tremendous strength in the region's high tech sector, the flow of equity has not benefited other key sectors. In particular, the forestry and agriculture sectors – long the foundation of northern Finalnd's economy – have continued to struggle, and job creation in the high tech sector has failed to provide opportunity for workers without high tech skills. In the end, while the Technopolis approach has been largely positive, it has not addressed all of the community's needs and concerns.

5.5 Quebec

Home to 40% of all risk capital funds in Canada, the Province of Québec has been actively involved in both profit-motivated and socially-motivated investing since 1990. A recent study showed that prior to the establishment of Local Development Centres, 254 regional and local funds were operating in the Province. The majority of the funds have benefited from government support, both provincial and federal. Active funds range between $20,000 (micro-enterprise development revolving funds) and $15 million (high-tech funds).

Tax credit programs to encourage individuals to invest in local or community economic development projects are still relatively limited in Québec. The Ministry of Industry and Commerce administers a program known as the *Régime d'investissement coopératif*, which provides tax credits for co-operative members and employees who invest in their co-operative through preferred shares. The goal of this program is to encourage capitalization of co-operative ventures in Québec, which have in the past suffered from under-capitalization. Since the regime's inception in 1985, co-operative members and employees have invested close to $200 million in their co-operative ventures.

Co-operative members and employees may deduct up to 100% of their preferred share investments on their provincial income tax, totaling up to 30% of their total revenue. An additional 25% deduction is added when the investment is in a small or medium sized co-operative. Another 25% can be added to the total income tax deduction when the investment is combined with a worker investment program, thus giving employees or members of a co-operative a maximum tax credit of 150% of their investment.

Eligible co-operatives include worker co-operatives, co-operatives in which at least 90% of their activities are comprised of manufacturing, processing or agriculture, and co-operatives in which at least 90% of their activities are comprised of providing services or products that allow members or clients of the co-operative to draw a business income. While the number of potential investors is limited when compared to the CEDIF program in Nova Scotia, the following individuals and institutions are eligible under the program:

- Members (individuals not corporate) and employees of the co-operative;
- Member associations of agriculture co-operatives;
- Employees of an association or corporation in which the members are co-operatives or federation of co-operatives; and
- Employees of a co-operative's subsidiary.

Members that invest in a co-operative must be active users of the services or products of the co-operative. In the case of worker co-operatives, this implies being a salaried employee of the co-operative. Shareholders of a company that is a member of a co-operative are not eligible to participate in the tax credit program.

The *Réseau d'investissement social du Québec* can be considered another CEDIF in the province. The RISQ utilizes corporate and government contributions to offer loans or loan guarantees and technical assistance support to eligible ventures. The RISQ is a non-profit venture capital fund, with a capitalization of $23 million. It provides financing to businesses at the start-up, consolidation or expansion phase. Its objective is to support the development of social economic businesses (i.e. not-for-profit and co-operative businesses) by injecting monies that act as a financial lever for successfully implementing the projects.

Investments in the form of loans and loan guarantees of up to $50,000 are available to qualifying business. Eligible businesses may also access a technical assistance contribution between $1,000 and $5,000 to help proponents conduct the required studies for the development of their project.

To date, RISQ has participated in 75 social economy projects in the past two years – 28 actual investments and 47 technical assistance projects. Investment amounts to date total more than $1.2 million while the technical assistance component has contributed some $300,000. However, RISQ investments have leveraged a total of $10.1 million in total investment, with an average cost per job created of only $2,333. Return on investment does not appear to be an important consideration, other than to finance administration and budget requirements of the RISQ.

Another Quϑbec initiative, the Solidarity Fund of the Quϑbec Federation of Labour (QFL), is an important development capital fund for small and medium sized businesses. Over 432,000 investors (primarily employees that contribute through payroll deductions organized by local representatives of the Fund) have provided a strong pool of capital for investment in Québec, directly or through the Fund’s development fund network in the following types of projects: start-ups, expansions, IPOs, consolidations, mergers, acquisitions, and export development projects. Established in 1983, the Fund topped the $4.1 billion mark in assets at the end of the last fiscal year.

Like other labor sponsored funds, individual investors benefit from a 30% provincial tax credit. The Solidarity Fund’s average annual rate of return over three years, five years and ten years has been 6.5%, 8.4% and 6.9% respectively. However, at 4.4%, the Fund’s annual rate of return for the fiscal year ended June 30, 1999 compares favorably with that of Canadian balanced mutual funds, which posted a 1.2% return for the same period.

More than just an institutional investor, the Fund also provides key technical assistance services to partner businesses through its development fund network. This network includes an impressive series of related funds and strategic alliances that the QFL has developed over the years. By working with regional solidarity funds, local investment corporations for job creation (known as SOLIDE), and other local funds, the Solidarity Fund QFL is able to meet the needs of companies throughout Québec in most sectors of activity, regardless of their size. The Fund also offers specialized Funds that were created to provide financial support to specific industry sectors with special needs, in order to help them consolidate and enhance their overall performance.

While these represent concrete examples of CED investment funds in Québec, the specific nature of the types of investment that they can make and the pool of investors or contributors that will help capitalize their programs are limited when compared to programs in Nova Scotia and New Hampshire.

6.0 Other Government Programs to Enhance Equity

Most provinces and territories offer a variety of tax credit programs linked to equity investments and, to a lesser extent, CED investments. The most common of these is a tax credit for funds invested in labour-sponsored venture capital funds. Such credits can be found in Nova Scotia, New Brunswick, Quebec, Ontario, Manitoba, Saskatchewan and the Yukon. British Columbia offers a similar venture capital tax credit. There are, however, a number of distinct provincial and federal programs of note, outlined in the balance of Section 6.

6.1 Nunavut and the Northwest Territories

6.1.1 The Risk Capital Investment Tax Credits Act:

This Act provides an incentive for northern residents to help build and share in the rewards of the development of a viable economy in their community and their Territory.

Northern taxpayers may receive a tax credit for purchasing newly issued shares of a registered community, employee, or labour sponsored venture capital corporation or by purchasing eligible securities from a Registered Territorial Business Corporation. Tax credits, which can be carried back three years, or forward seven years, can amount to a one time 30% credit on an investment of up to $100,000 (for an individual) or one time 15% credit on an investment of up to $200,000 (for a corporation).

6.2 Yukon Territory

6.2.1 Small Business Investment Tax Credit Program:

The Small Business Investment Tax Credit Program in the Yukon is intended to create jobs and promotes economic growth and expansion by providing more access to capital for small business people. The credit enables taxpayers to invest in Yukon companies through self-directed RRSPs.

The program, which became effective in July of 1999, permits qualifying investors to claim a personal income tax credit equivalent to 25% of their investment in an eligible Yukon business. The credit is limited to a maximum of $25,000, representing an investment of $100,000.

6.3 Manitoba

6.3.1 Manitoba Equity Tax Credit Program

The province of Manitoba and the Winnipeg Stock Exchange (WSE) formed a partnership in 1999 to provide Manitoba residents with an incentive to invest in Manitoba companies. The Equity Tax Credit encourages local investors to purchase new shares of small and medium-sized Manitoba companies on the WSE. The tax credit is 5% per year for up to three years, and the maximum Credit for an individual in any year will be $1,500. This initiative is another step in the Government's ongoing plan to expand local capital markets, in order to assist the Manitoba economy in reaching its full potential.

The program is administered by the WSE on behalf of the province. Companies with less than 500 employees (at least 25% of whom are employed in Manitoba), and with no more than $50 million in total assets are eligible to issue these special new common shares.

6.3.2 Manitoba Grow Bonds

Manitoba Grow Bonds provide Manitobans with an opportunity to participate directly in strengthening local economies and in creating jobs. Essentially, communities plan and manage bond offerings to raise capital, which is then used to finance eligible new business opportunities and expansions. Only Manitoba residents and corporations are eligible to purchase Grow Bonds. The incentive in purchasing these types of bonds is that the principal is guaranteed by the province.

Grow Bonds bring together local investors and local entrepreneurs for as little as $100 to create new economic opportunities and prosperity for rural Manitoba communities. The bonds are available in denominations of $100, limited to individual investments of $50,000 or 10% of an issue, whichever is less, available in 5-year terms.

6.3.3 Manitoba Farm Diversification Program:

In March of 2001, the province of Manitoba announced that an additional $50 million is being pumped into a provincial program to help Manitoba farmers diversify their operations and build a stronger rural economy.

The new funding for the enhanced Diversification Loan Guarantee Program will provide farmers with access to $200 million in private financing. The program is administered by the Manitoba Agricultural Credit Corporation (MACC), which guarantees project funds borrowed from commercial lenders. The Diversification Loan Guarantee Program was launched in 1995 by MACC and has been successfully operated in partnership with major chartered banks, credit unions, and *caisse populaires* in Manitoba.

The program supports projects (such as the introduction of a new, unproven product) where financing might not normally be available from private sector lenders. By sharing risk and making it more manageable, the program encourages commercial lenders to invest in new Manitoba agricultural projects. The agricultural sector and the province both benefit, as these new projects contribute significantly to rural communities and to the health of the provincial economy.

Guarantees are for 25 per cent of the loan. Over 90 projects have been approved since the program began in 1995, with guaranteed loans during that time totalling $75.6 million. Loans range from $50,000 to $3 million, and have averaged $830,000.

6.4 Ontario

6.4.1 Ministry of Agriculture, Food & Rural Affairs (OMAFRA)

The Provincial Government of Ontario's Ministry of Agriculture, Food and Rural Affairs (OMAFRA) offers a number of programs for the agricultural industry. There are nine categories of assistance programs with each category having a number of different programs. The categories are broken down as follows:

1. Individual Farm Business Programs (10)
2. Income Safety Net Programs (5)
3. Loan Programs (6)
4. Livestock Programs (5)
5. Compensation Programs (3)
6. Business Consulting Assistance Programs (2)
7. Educational / Employment / Advisory Programs (7)
8. Programs to Build Business Opportunities (3)
9. Programs for General Interest (8)

Examples of these programs include the initiatives outlined in the balance of Section 6.4.1.

Farmland Property Tax Programs
In January of 1998, a new Farmland Taxation Policy was introduced by the Ontario government. Under the new policy, farm properties satisfying certain eligibility requirements will be identified in the Farmlands Property Tax Class and will be taxed at 25% of the municipal residential/farm tax rate. The farm residence, and one acre of land surrounding it, will continue to be taxed as part of the residential class.

Healthy Futures
The goal of the Healthy Futures program is to ensure that Ontario's dynamic agri-food industry will continue to generate jobs and economic growth, as well as protect the environment on which it depends. The Healthy Futures program invests in three main program initiatives: rural water quality, field to fork food safety and quality, and Healthy Futures innovation. Those that can apply include for assistance under the program include:

- Not-for-profit agricultural, commodity or food industry groups, rural municipalities, conservation authorities and other rural community organizations
- Partnerships among Ontario farmers and agri-food businesses
- Alliances of two or more arm's-length businesses in the agri-food sector

6.5 Newfoundland and Labrador

6.5.1 Direct Equity Tax Credit Program:

Last year, the Province of Newfoundland and Labrador announced a new equity tax program to address the challenge of raising capital in rural areas. The program provides a tax credit of 20% for private investors who make a direct investment through the purchase of newly issued shares in an eligible business on the North East Avalon peninsula, and 35% to investors who make a direct investment in an eligible business in the remainder of the province. This incentive for rural areas is among the most aggressive in Canada.

The program is designed to support small businesses in growing areas of the economy and to meet the particular challenges in rural areas of the province. The tax credits are intended to finance the start up, modernization, expansion, or growth of eligible small businesses. Individual investors are required to keep their investment in the company for a minimum of five years.

6.5.2 Venture Capital Tax Credit:

In 2000, the Province of Newfoundland and Labrador also announced a new Labour Sponsored Venture Capital Tax program, which offers a 15% provincial tax credit, combined with a 15% federal tax credit to individual investors. The mandate of the venture capital corporation is to reinvest the pool of funds it raises in eligible businesses throughout the province.

6.6 Prince Edward Island

6.6.1 Equity Investors Incentive Program:

The objective of this program is to attract private sector investment to PEI businesses, thus reducing the requirements for conventional term debt and working capital financing. The Equity Investors Incentive program provides a non-repayable incentive to investors to encourage investment in eligible PEI-based business. The incentive is calculated at 20-25% of the purchase price of the equity investment made in the small business.

The incentive is considered to be a reduction to the cost base of the shares in the small business and not as taxable income to the investor.

6.7 Federal Agriculture Programs

Extensive research into the number and nature of programs at the federal Ministry of Agriculture and Agri-Food has revealed that no equity tax credit programs are currently in place. This has been confirmed in discussion with Department personnel. However, a number of innovative assistance programs do exist, some of which have been outlined in the balance of section 6.7. These programs cover both equity and debt financing options.

6.7.1 Farm Income and Adaptation Policy

The Federal government, in conjunction with the provinces and industry representatives, has developed a broad farm income safety net framework. The Government of Canada's approach has been to develop such programs as Net Income Stabilization Account (NISA) and Canadian Farm Income Program (CFIP) that will provide farmers with support in dealing with income shortfalls while also helping them to prepare for the future with new programs and private risk management tools.

Within the Strategic Policy Branch of Agriculture and Agri-Food Canada (AAFC), the role of the Farm Income and Adaptation Policy Directorate (FIAP) is to provide overall guidance and direction to the development of federal policies related to agricultural safety net programs. This Directorate works with industry groups and the provinces in terms of providing and reviewing analysis as well as carrying out ongoing work in the design of safety net programs and for developing new safety net programs, and disaster programs.

This Directorate, through the Policy Development Division, is also responsible for providing guidance and direction on the development of federal policies related to agricultural safety nets, risk management, farm finance, farm inputs, taxation and related areas. The Policy Development Division works with industry groups and the provinces to undertake research and analysis on the performance of safety net programs, and the development of new safety net income and disaster policies.

As a result of this role, it appears likely that, should the Department ever address the possibility of an equity tax credit program for CED purposes, or the creation of agricultural CEDIFs in cooperation with community organizations, the Policy Development Division will likely spearhead such work.

The Farm Income and Program Analysis Section of the FIAP Directorate works with the provinces to develop short-term forecasts of revenue expenses and income for the sector. These forecasts are used to monitor the financial health of the industry and assess the need for changes to existing safety net programs. Information and data to assess the financial health of the industry and to design changes to safety net programs is collected through the Farm Data and Analysis Section of the FIAP Directorate.

It is recognized that safety net programs may not be effective for all farmers. AAFC is the lead department for the design and delivery of adaptation programs to help these individuals exit from agriculture. The Farm Financial Programs Branch is responsible for the delivery of adaptation programs. Research and analysis relating to the need for adaptation programs is carried out by FIAP.

Adaptation Policy Unit of the FIAP Directorate is a focal point for adaptation policy development in the Strategic Policy Branch. This unit works with other units inside and beyond the department to examine the issue of how the agriculture and agri-food sectors in Canada should be adjusting to changing economic circumstances and what programming is needed to support positive change. Interfacing with safety net policy is an important consideration for developing adaptation policy.

6.7.2 The Net Income Stabilization Account

NISA is a voluntary program developed jointly between producers and the Government of Canada and participating provinces. The Program is designed to help producers achieve long-term farm income stability on an individual basis. By providing producers the opportunity to deposit money annually into their NISA account and receive matching government contributions, their NISA account grows. In lower income years, producers can make withdrawals from the funds they have set aside.

Producers can make a base deposit of 3% plus the top-up of 1%, meaning that all producers can deposit 4% of their eligible net sales annually and receive full matching government contributions (1.5% provincial and 2.5% federal). All producer deposits (matched and unmatched) earn the bonus interest of 3% above regular interest rates.

6.7.3 Farm Credit Canada

FCC is a federal Crown corporation established in 1959 to provide financial services to farm-related businesses. FCC offers equity financing both directly and in partnership with other equity investors, and provides both financial and business management services to producers and farm-related businesses. FCC works in partnership with the public and private sectors whenever possible to avoid duplication of existing services.

FCC can extend equity financing to producers and farm-related businesses either directly or in partnership with others. FCC often acts as a catalyst by attracting needed equity capital to the agricultural industry in rural Canada.

6.7.4 Farm Improvement and Marketing Cooperatives Loans Act

FIMCLA is a federal government guaranteed loans program designed to increase the availability of loans for the purpose of the improvement and development of farm buildings and the processing, distribution or marketing of farm products by cooperative associations. The program facilitates the availability of credit to both farmers and their cooperative associations to improve farm assets, strengthen production and/or improve financial viability.

Established in 1988, FIMCLA has helped more than 130,000 farmers and their marketing cooperatives grow their businesses by guaranteeing loans through lending institutions. Borrowers benefit from advantageous interest rates, lower equity requirements and interesting repayment terms. Individual farmers, farm partnerships and farm corporations can apply for up to $250,000 under FIMCLA, while up to $3 million is available for cooperative associations.

The Program:

- Encourages investment in new machinery, livestock, buildings and technology and facilitates investment in alternative farming initiatives;
- Provides access to intermediate credit through lending institutions such as Chartered Banks, Alberta Treasury Branches, Credit Unions, *Caisses Populaires*, Trust Companies, Loan Companies and Insurance Companies;
- Helps farmers and their cooperatives with their financing needs through guaranteed loans resulting in market expansion, farm innovation, value added-processing and environmentally sustainable farming;
- Offers loans for the consolidation or refinancing of debts incurred for eligible loan purposes.

7.0 Equity and Debt in the Co-operative Context

A co-operative can be defined as an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. Common cooperative models include:

- Worker co-operatives – owned and controlled by the people who work within them;
- Housing co-operatives – an organization which offers accommodation to its members but is also owned and controlled by them;
- Credit Unions – savings and loan co-operatives providing financial services to their members;
- Community co-operatives – provide a service for, and are controlled by, members of a local community;
- Consumer co-operatives – bring people together to provide a means for them to save, borrow and manage their finances.

All types of co-ops are guided by the same general principles:

- Voluntary and open membership
- Democratic members control
- Member economic participation
- Autonomy and independence
- Education training and information
- Co-operation amongst co-operatives
- Concern for community

While co-operatives can raise capital through various means, differing legislative frameworks between provinces and between provinces and the federal government have direct impacts on the ways and instruments that co-operatives may adopt to capitalize their ventures. Although the balance of Section 7 addresses mechanisms for capitalizing co-operative ventures, the information provided is aimed at providing a general overview of their possible financing structures.

7.1 Equity Financing and Co-operatives

Depending on the co-operative legislation, a co-op can raise equity by issuing shares and offering other investment instruments to members, and in some cases, non-members. Co-operative shares are typically par value shares. This means that when a co-op redeems or buys back its shares from members or other investors, the amount they receive for each share is equal to the amount originally paid for the share.

In some jurisdictions, a co-op may choose to pay an extra amount or premium for preference shares they redeem to protect investors against inflation. Paying a premium will help ensure that the value of a co-op's shares keeps pace with inflation. A co-op may also pay investors a return on its shares. This return is called a dividend and is directly attributed to the co-op's performance.

While each province and Federal legislation provide mechanisms for members to invest in their co-operative, investments in co-operatives by non-members are not as evident in some jurisdictions. For example, New Brunswick co-operative legislation fails to provide provisions to allow non-member investments in co-operatives. This definitely impacts on the ability of a co-operative to raise sufficient capital.

7.2 Other Ways to Raise Equity

In order to ensure appropriate capitalization levels, co-operatives can require that members use some or all of their patronage returns to buy more shares in the co-operative. By doing so, a co-op can ensure that its equity grows each year, provided of course that the co-op has earned enough to pay patronage returns in the first place.

Distribution of surpluses may also be made in the form of loan capital accounts that allow co-operatives to transfer equity to members while ensuring financial stability of the organization. Another way for a co-op to use its own earnings to increase its equity is to pay out dividends in the form of shares rather than cash.

7.3 Advantages of Equity Financing

Equity financing gives a co-op flexibility. For example, if a co-op raises enough equity to buy significant assets, it may use these assets to borrow more funds. In this way, a co-op's equity can be used to attract more financing.

Although it is wise to establish a record of paying dividends or transferring surpluses to investors, a co-op (like other corporations) is not legally required to do so. Whether a co-op pays dividends depends on its earnings. By contrast, creditors have the right to sue a co-op for missed interest or principal payments on loans. If a co-op has some difficult times when it is short of cash, it will have more flexibility with a strong equity base.

7.4 Debt Financing and Co-operatives

If a co-op needs to borrow money, it may do so in three ways:

Member Loans

Co-operative may gain access to much needed capital in the form of member loans. Member loans are loans that may be required as a condition of membership in a co-op. Co-ops must repay member loans, together with any accrued interest, when the member leaves the co-op. A co-op may also require members to lend it some or all of their patronage returns. Patronage returns loaned back to a co-op are called “patronage loans”. By requiring members to make patronage loans, a co-op can use its own earnings for debt financing.

Other Loans

If a co-op needs more money than it can borrow in the form of member loans, it may borrow from members, non-members or financial institutions. A co-op's ability to get more loans and the interest rate it has to pay on these loans depends on how risky lenders believe the co-op to be. If a co-op has few assets, or if its assets are already financed by borrowed funds, the co-op will probably have a hard time borrowing more money and will have to pay higher rates of interest.

Debentures

While not available in all jurisdictions, co-operatives may consider issuing debentures. Specific assets are usually used as security by co-ops issuing debentures. If a co-op has fixed assets financed by equity, such as real estate and buildings, it may be able use these to attract investment in its debentures. Co-ops may issue many kinds of debentures, but usually they promise to make regular interest payments and to pay off the principal on a certain date. If a co-op fails to make these payments, debenture holders have the right to sue the co-op. There is no cap on the rate of return a co-op may offer investors on its debentures, although it is necessary to determine how much the co-op can afford.

7.5 Use of Surplus

A co-op's surplus is what is left of its earnings after paying operating expenses, such as electricity and interest on loans. How a co-op uses its surplus is important on the co-operative’s overall financing. A co-op will likely need to keep part of its surplus in the form of retained earnings or reserves. Retained earnings are needed to finance, for example, any expansion in operations or replacement of worn-out machinery. Before deciding how a co-op will distribute its earnings to members and shareholders, it should determine the amount of retained earnings it needs.

Co-ops have traditionally distributed most of their surplus to members as patronage returns. If a co-op plans to attract large amounts of equity by convincing investors it intends to pay dividends on its shares, it will have to balance this commitment with members' desire for patronage returns.

7.6 Tax Note

Different ways of distributing surplus have different tax implications for a co-op as well as for its members and investors:

- Patronage returns are paid out of a co-operative's pre-tax income and are recorded as an expense. Paying patronage returns thus lowers the amount of tax a co-op may have to pay.
- Patronage returns paid by worker co-ops and some kinds of non-consumer co-ops are taxed as income earned by the member. For example:
    1) In a worker co-op, both wages and patronage returns are paid out of the co-op's pre-tax income. Like wages, therefore, patronage returns are taxed in the hands of the recipient.
    2) Farmers are allowed to deduct the cost of supplies as a business expense. Patronage returns paid by a farm supply co-op lower the cost of these supplies. To ensure that only actual expenses are declared, farmers are required to report patronage returns as earned income.
- Dividends on shares are paid out of a co-op's after-tax income.

Non-member investors or shareholders may claim a federal tax credit for dividends paid by a co-op.

8.0 From Theory to Reality: Implications of Equity Financing for CED

It is clear that equity investment provides significant opportunities for CED initiatives. Equity investing strategies can:

- Generate significant capital (money) for CED initiatives
- Ensure that capital remains within disenfranchised communities, and that it actively supports economic growth
- Decrease a CED initiative's reliance on traditional sources of capital (e.g. commercial banks)
- Assist CED initiatives in the start-up phase, when debt financing is generally unavailable
- Broaden community participation in CED initiatives by involving both investors and entrepreneurs

The experience of New Hampshire and Nova Scotia, among others, shows that equity investing for CED purposes can be effective. While still a relatively new concept, equity investing for CED has led to the creation of a variety of CEDIFs across North America and Europe, and opportunity exists for more to be created. This portion of the discussion paper will examine some of the practical issues related to equity investing for CED purposes, with some preliminary insights in how to overcome them.

8.1 Regulatory Obstacles

In Canada, enterprises seeking equity investments are normally required to prepare and issue what is known as a "prospectus", a detailed document disclosing all elements and details of a proposed venture's operations. They are also required to meet continuous disclosure regulations, and to sell shares (equity) only through registered dealers, who receive a commission. This process is extremely costly – generally several hundred thousand dollars or more.

Each province has regulations of this nature, most of them based on Ontario's security regulations. The purpose of these regulations is to prevent fraud, but in practice, the regulations also serve as an obstacle to the use of equity for smaller projects, including many CED initiatives. The high cost of meeting regulatory requirements makes equity financing of small CED initiatives untenable.

Recently, some provinces have adopted additional regulations to offer exemptions to certain kinds of equity investments. In Nova Scotia, for example, private issuers, seed capital and sophisticated investors are exempted from the regulations in some ways. Each of these continues to pose some problems from a CED perspective, with governments slow to interpret exactly what these exemptions mean and when they may be applied.

Private issuers, while they may make equity investments, are prohibited from offering their shares to the public. This causes difficulty, as regulators have been reluctant to define who is or is not a member of the public.

Seed capital has presented difficulty in a similar fashion. Nova Scotia requirements for seed capital investment dictate that each equity investor must have access to "substantially the same information" as would normally be available in a prospectus. Although this eliminates the need for a costly, formal prospectus, regulators have often been unable to decide how much information or what kind of information constitutes "substantially the same information" as would appear in the prospectus.

The sophisticated investor exemption does not generally affect CED initiatives, as it requires each individual to invest a minimum of $150,000.

The result of this regulatory structure in Nova Scotia has been a general slowing of the approval process for CED initiatives seeking equity investment under the provincial tax credit program. CED investments are still subject to four separate pieces of legislation:

- Nova Scotia Companies Act
- Nova Scotia Securities Act
- Nova Scotia Community Economic Development Corporation (CEDC) Exemption Rule
- Nova Scotia Equity Tax Credit Act

The first two Acts are not overly problematic, as they outline only normal requirements for reporting or conducting affairs that all businesses in Nova Scotia must follow. The Nova Scotia CEDC Exemption is what allows the prospectus requirement to be waived, but it imposes in its place a requirement for an "offering document". This document is to include:

- An indication of the minimum and maximum amounts of equity to be raised
- The securities being offered
- The offering price
- All offering costs
- All risk factors
- Any agents, relationships and compensation to agents inherent in the offering
- Financial forecasts and projections, and an indication of the use of all proceeds
- A list of officers, directors and key personnel
- An indication of any debts and debt-holders
- Any other pertinent information regarding operating the enterprise or investing the equity funds acquired through the offering.

While this offering document is less expensive and less time-consuming to prepare than a prospectus, the Nova Scotia experience to date suggests that government review and approval of the offering document is often a significant hurdle. In general, close coordination of the CED initiative with government interest is required, and numerous and time-consuming revisions of the offering document may be required. Although this situation may change as government becomes more familiar with (and comfortable with) CED equity investments, this issue appears to be a legitimate concern in all Canadian jurisdictions where equity investing for CED is currently carried out.

Finally, to be eligible for the tax credit incentives available in Nova Scotia, the CED initiative seeking equity investment must be registered with the provincial Ministry of Finance under the Equity Tax Credit Act. This must be done before submitting the offering document, and requires the venture to submit:

- Financial statements
- Articles of association
- A community development plan showing a development strategy
- An indication of the amount and type of shares to be issued
- The provisions for the issue of security

As with the Nova Scotia CEDC Exemption Rule, although the process for Equity Tax Credit Act approval is not costly, it is complicated and time-consuming.

The conclusion that may be drawn form this information is that while most provinces now have some form of regulatory framework in place to allow and encourage equity investment for CED purposes, the process necessary to receive regulatory approval is complicated and time-consuming. Although this may change in the future, as governments become more familiar with the process, and as the track record of CEDIFs and other equity investments in CED is established, it remains an important practical consideration in planning such an initiative.

8.2 Rates of Return

Equity investors, like all others, normally seek what is known as a "return on investment" or ROI. In essence, they seek a return of capital greater than what they initially invested. In economics this is "rational" behaviour. The amount of money returned on an investment can be calculated as a percentage of the original investment. This percentage is known as the "rate of return".

Some of the measures used to determine ROI include:

Internal Rate of Return (also known as Dollar-Weighted Rate of Return)
The internal rate of return is the discount rate at which cash outflows of an investment equal cash inflows.

Return on Capital (ROC)
Return of capital measures cash distribution resulting from the sale of a capital asset, or securities, or tax breaks from depreciation.

Return on Assets (ROA)
An indicator of profitability, return on assets is determined by dividing a company's net income for the past twelve months by the total average assets, with the result shown as a percentage.

Return on Equity (ROE)
An indicator of profitability, return on equity is determined by dividing a company's net income for the past twelve months by common stockholder equity, with the result shown as a percentage.

The rate of return of a particular kind of investment may be affected by a government's taxation policy. Different types of investments and their returns are subject to different levels of taxation. In essence, equity tax credits are an attempt by government to alter the rate of return for those making equity investments. The effect of the tax credit is to artificially raise the rate of return.

8.2.1 Rates of Return and Operating Costs

CEDIFs and other equity investment funds incur significant operating costs. Equity placements are most often made with the assistance of brokerage firms, which have access to large numbers of potential investors through a network of sales staff across the country. To establish and maintain such a network is a costly prospect. Even if an equity investment does not require such a brokerage firm, but instead relies on a smaller, more local pool of investors, there is still a need to market and publicize the investment opportunity. Such activity inevitably incurs costs.

Furthermore, although some equity investments are made into individual companies, many are made into larger pools of investment capital – CEDIFS, labour-sponsored funds, RRSPs, etc. These larger pools require expert management and qualified staffing. Again, this can add significant costs to the equity investing process.

Because of these and other operational costs, equity investments – particularly in large funds – must generate large enough rates of return to provide resources to cover both operational costs and the investor's expected rate of return. This reality means that, to some degree, it is necessary for equity investment pools and funds to be selective about the investments they make on the basis of probable returns.

In limited instances, operating costs can be covered to some extent by the use of volunteer labour. This is a risky proposition, as it is only viable if the volunteer support is permanent. Should volunteers lose interest, burn out or be drawn into different activities, the only way to offset this loss is by spending more funds on operational costs, compromising the fund's rate of return. Investors pursuing rational investment strategies will be wary of such investments.

There is, however, one mechanism for working around the problem of operational costs. It is possible that a third party, usually government, can be asked to administer the equity investments (as in New Hampshire), or asked to provide an operating grant to cover these expenses. This latter model was proposed to the Atlantic Canada Opportunities Agency (ACOA) by a collection of Nova Scotia CED agencies in 1998, but was rejected.

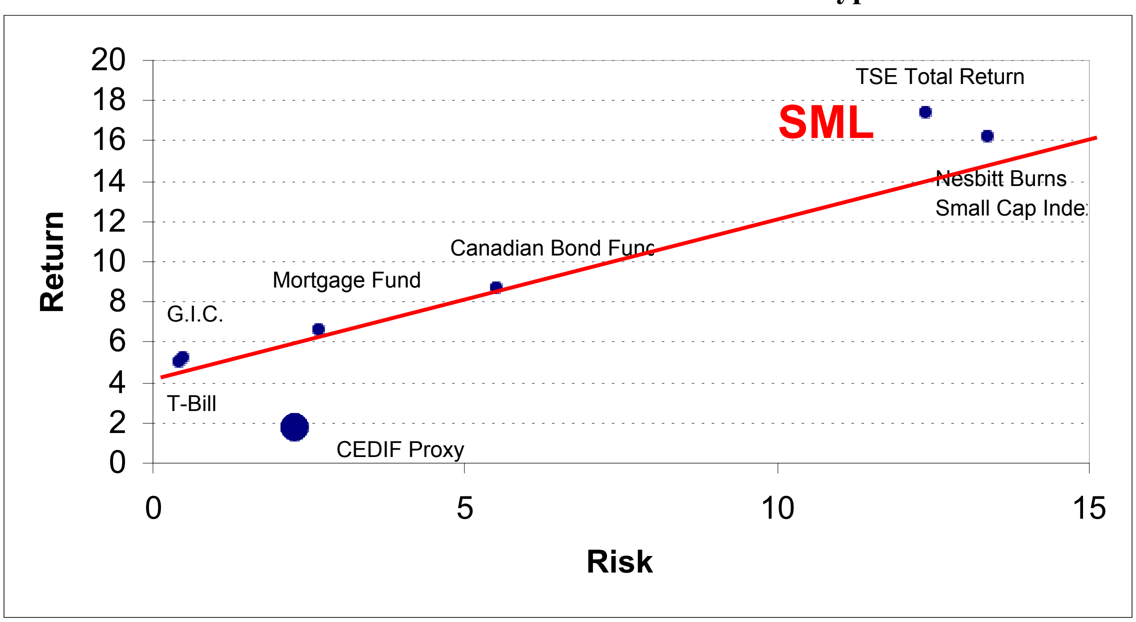
8.2.2 Rates of Return and Investor Appeal

So-called rational economic behaviour suggests that, all other factors being equal, investors will seek the highest rate of return available. However, in the real world, different investments carry different levels of risk. In general, investments with a higher risk level also have a higher rate of return. As discussed earlier, equity investments have a higher level of risk attached to them than fixed-income or debt investments. As a result, equity investments offer a higher rate of return.

Every individual investor plays a subconscious balancing game between return and risk, determining what investments are most attractive from their individual perspective. Appendix K contains two recent articles on this process of analysis: P.V. Viswanath's "Optimal Portfolio Construction and Selection" and Campbell Harvey's "Optimal Portfolio Control".

The risk vs. return question can most easily be expressed mathematically, however. The results of such a mathematical analysis are displayed on the graph below.

Figure D
Return Vs. Risk for Standard Investment Types



On the Y-axis of the graph is the rate of return, expressed here as an annualized percentage. On the X-axis is the level of risk, expressed here as the standard deviation or fluctuation in the price (i.e. value) of an investment. The line running from the lower left to the upper right is referred to as the Security Market Line, or SML.

The SML represents the point at which investments can be said to be rational or irrational from an economic perspective. Investments that strike a balance between risk and return that is at or above the SML are said to be rational, while those below the SML are said to be irrational. In other words, those below the SML do not produce a high enough rate of return to interest most investors.

It should be noted that the exact position of the SML varies for every investor. This is because taxation levels and approaches vary from province to province, and because different levels and sources of income are taxed at different rates. The SML in Figure D can be said to represent an average Canadian investor.

Although CEDIFs and other equity investments for CED purposes have never been studied to determine their standard rates of return, it is reasonable to expect that they would be similar to the returns of labour-sponsored venture capital funds.[8] To this end, Figure D uses such funds as a proxy for CED investments.

With an average five-year rate of return of only 1.79% per year, it is clear that CED investments are likely to offer much lower returns than other kinds of investments. Indeed, the returns are so low as to make investment in them an irrational economic behaviour.

In order to make equity investing in CED more rational, it is necessary either to raise the rate of return, or to lower the risk involved in the investment. This can be done in only one way: the provision of tax credits or other incentives that have the net effect of moving the investments into rational economic territory.

8.3 Tax Credits and other Incentives

Governments across North America and around the world have come to recognize the value of investments in CED initiatives. They have also come to realize that these investments, being irrational in economic terms, require encouragement through incentives. One avenue for doing this is through tax credits, discussed in detail above and addressed briefly in Section 8.3.1 following. Other incentives are possible, including tax deductions (discussed in Section 8.3.2), investment guarantees (Section 8.3.3), foreign investment allowances (Section 8.3.4) and rate of return guarantees (Section 8.3.5). While tax deductions and investment guarantees have been employed in limited

[8] Although Canadian figures have been used here, preliminary research suggests that similar results are evident in the United States. See, for example, Venture Economics, *Investment Benchmark Reports: Venture Capital* (New York, 1996), p. 281.

circumstances, foreign investment allowances and rate of return guarantees have never before been proposed for CED investments.

8.3.1 Tax Credits

A tax credit, as discussed in detail in Section 4.1, is a tool used by government to allow an investor to reduce the amount of tax that he or she must pay at year end. The effect of a tax credit on rate of return, and therefore on the rationality of an investment, can be observed in Figure D depicting the Security Market Line (SML). If a CED investment would normally have a rate of return of 1.79%, as depicted on the chart, a tax credit has the effect of artificially increasing this rate of returning, and pushing the investment up the Y-axis of the graph. In this way, a tax credit moves the CED investment closer to the SML. If the tax credit is large enough, it will move the CED investment to or even above the SML.

Although CED investments have never been studied in this way, some preliminary conclusion may be drawn on the basis of the Figure D. Assuming that labour-sponsored venture capital funds are a valid proxy for CED investments, a tax credit would probably need to be about 68.4% before it would raise the CED investment to the SML.

8.3.2 Tax Deductions

A tax deduction is similar in many ways to a tax credit, with one notable exception. A tax deduction is used on a tax return to reduce the amount of income to be taxed; that is, it is applied before payable taxes are calculated. A tax credit, on the other hand, is applied against taxes owed; that is, it is applied after payable taxes are calculated.

In the context of a CED investment, the impact of a tax deduction is identical to the impact of a tax credit. As graphed in Figure D, it would move the position of a CED investment up the Y-axis, and closer to the SML. Therefore, tax deductions also improve the rationality of CED investments.

The question of whether a tax credit or a tax deduction is better has no easy answer. From a government perspective, a tax credit is probably easier to manage. On the investor's side, the appeal of one or the other would be different according to each individual investor's situation. For some investors, a tax deduction might be a better incentive than a tax credit, while for others the reverse would be true.

8.3.3 Investment Guarantees

An investment guarantee is an offer from a third party, usually government, to protect some portion of an investment. The Nova Scotia CED Tax Credit program, for example, offers a 20% investment guarantee. Under this program, if a CED initiative becomes bankrupt, the government will pay 20% of the invested amount back to the investor.

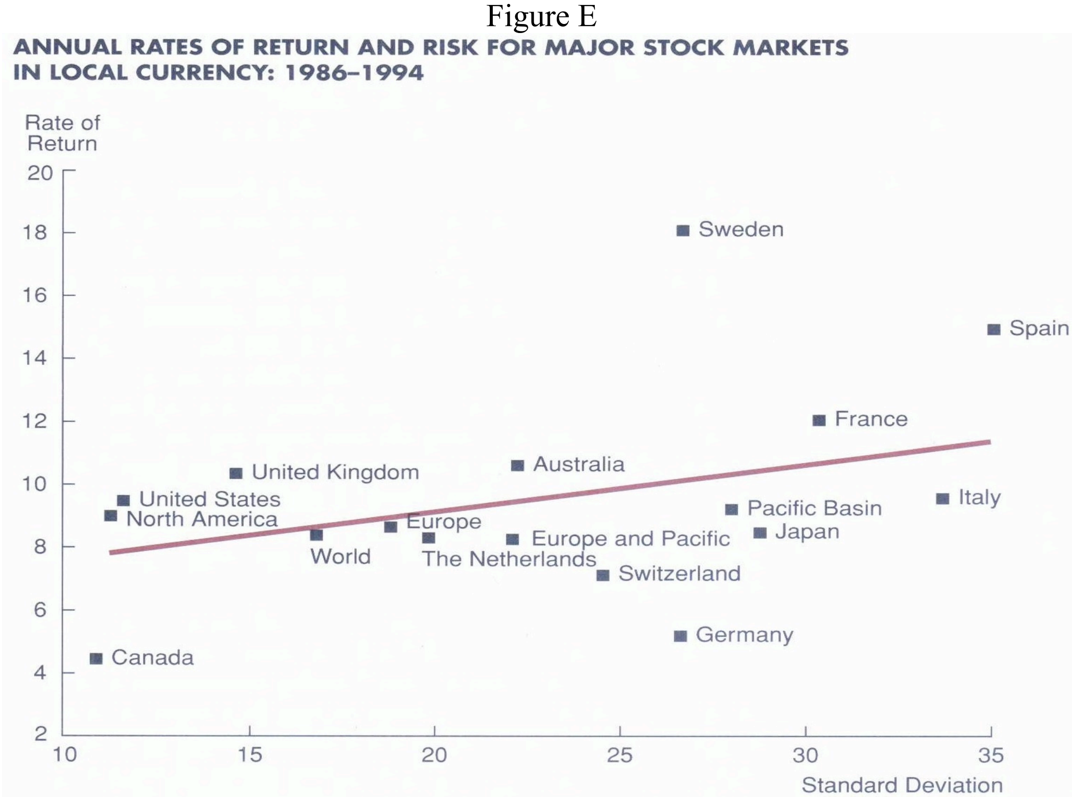
Investment guarantees operate differently than tax credits or tax deductions. Rather than moving an investment up the Y-axis and closer to the SML, they move an investment to the left along the X-axis, by decreasing risk. If they succeed in moving the investment far enough to the left, the risk decreases to the point where the investment meets or exceeds the SML at the lower left corner of the graph.

The applicability of this incentive in the case of CED investments is questionable, however. In Figure D, it is clear that even a 100% guarantee might not cause the CED investment to intersect with the SML. Furthermore, since almost 80% of new business ventures fail, a 100% investment guarantee would be cost prohibitive. Incentive programs utilizing both tax credits and partial investment guarantees may be effective, but no study has been carried out to determine the most efficacious levels of such guarantees.

8.3.4 Foreign Investment Allowances

Just as different types of investments offer different rates of return, investments in different countries also tend to offer different rates of return. In part this is due to an economic development concept known as convergence theory, which postulates that different economies grow at different speeds. Although beyond the scope of this discussion paper, research into this concept has demonstrated that Canadian investments generally offer a much lower rate of return than investments in many other countries. This data is graphed in Figure E.

Figure E



If Canadian investors followed rational economic behaviour, they would invest most of their money in opportunities outside of Canada.[9] To prevent this from happening, the federal government uses a variety of tools and regulations to discourage or prohibit foreign investment. The best known of these is a 20% limit on foreign content in an individual's RRSP. This limit guarantees that 80% of Canadian RRSP money stays in Canada.

One possible incentive to promote investment in CED initiatives is to waive or relax foreign investment rules for those who invest in Canadian CED ventures. Although this does not directly impact the rate of return of the CED initiative, it provides the opportunity to raise the rate of return of the investor's overall "portfolio", or collection of investments. As a result, while the CED project may not move towards the SML line in Figure D, the investor's entire portfolio might move above the SML.

A viable foreign investment allowance scheme might allow matching investments. For example, for every $1,000 invested in a Canadian CED initiative, an investor would be allowed to invest an additional $1,000 in a foreign opportunity.

While attractive in many ways, such an approach is problematic from a CED perspective. One of the goals of CEDIFs and incentives to invest in CED projects is to discourage the outflow of capital from disenfranchised communities. In some ways, a foreign investment allowance could be said to encourage such an outflow.

8.3.5 Rate of Return Guarantees

A rate of return guarantee is similar to an investment guarantee, in that a third party (usually government) offers a promise to ensure compensation should an investment fail or not perform as expected. In the case of a CED initiative, it would be necessary to determine in advance what rate of return would be sufficient to attract investment. In other words, it would be necessary to determine what rate of return moves the CED investment to or above the SML as shown in Figure D. The third party would then guarantee this rate of return.

Such a guarantee would obligate the third party to make up the difference in the event that the real rate of return was lower than the guaranteed rate of return. In Figure D, the guaranteed rate of return would need to be about 6%, while the actual rate of return is just under 2%. The 4% gap would represent capital paid to the investor by the third party on an annual basis.

In essence, this makes an equity investment in a CED venture behave as if it were a fixed-income or debt investment. Such an action would be extremely costly, and could potentially have impacts on a venture's productivity. As a result, it seems unlikely that a third party could be found to provide such a guarantee.

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[9] For a fuller discussion of this topic, and to view the source of the graph at Figure E, see Frank K. Reilly and Keith C. Brown, Investment Analysis and Portfolio Management (Dryden Press, 1997), p.72.

8.4 Technical Assistance Provisions

Other non-financial incentives have been used in some cases to make CED investments more attractive. Chief among these has been technical assistance.

Businesses, including CED ventures, can often benefit from outside expertise and research. In fact, such outside assistance can often dramatically increase the overall viability of a business venture. Some existing CED equity programs, such as the one in New Hampshire, allocate significant resources to providing technical assistance. In New Hampshire's case, technical assistance grants of US$1,000 to US$5,000 are made to many CED initiatives. These have the overall effect of lowering the risk level of an equity investment.

In Canada, there are a number of excellent technical assistance providers, including the Community Economic Development Technical Assistance Program (CEDTAP), the Canadian Worker Co-operatives Federation and the Reseau d'investissement social du Québec (RISQ). For the most part, however, this technical assistance has not been directly linked to equity investment opportunities.

8.5 Exit Routes

One of the most significant and unresolved questions facing CED investments is "exit routes". An exit route is a process by which an investor may withdraw his investment from a project at a future date. In other equity investments, exit routes are easy to use. Many stocks may be sold on the stock market, or an RRSP may be cashed in.

Indeed, in standard equity investments, there are four basic strategies through which investors may exit their investments, and realize their returns:

1. Sale of the investor's interest to a third party;
2. Sale of the investor's interest to the company;
3. Sale of the company to a third party;
4. Sale of the investor's interest to another shareholder.

CED investments are much more problematic. CED initiatives by nature are small and local. Selling an investor's interest to another shareholder may not be an option, because all shareholders will face the same exit problem in the long run, and because all shareholders are likely to be small investors. Likewise, a small firm may not have the resources necessary to purchase shares (equity) back from shareholders, even when it is a successful business. Sale of the shares or sale of the company to a third party may not be practical, as such a party may not exist.

Exit strategies are complicated by the incentives offered to increase an investor's rate of return. Although initial investors will receive any applicable tax credits or guarantees, anyone who purchases the equity from these investors will likely not receive such incentives (this is the case in the Nova Scotia program, for example.) This has the effect of moving the CED investment away from the Security Market Line (SML) outlined in Figure D, and making the CED investment irrational.

No consistent solution to the exit route dilemma has been identified among CED investments. The best option seems to be to concentrate CED investments under a larger umbrella, creating a pool of money for a variety of CED investments. This pool or investment fund can then be made large enough to rotate investors in and out over time, much like a standard mutual fund. All investors at every stage receive applicable tax credits or other incentive benefits, while the rate of return and infusions of new cash as new investors join allow those exiting the fund to be paid back.

There are risks to this kind of an approach. It assumes that governments will keep incentive programs in place indefinitely, and that there will continue to be a pool of potential investors who see the investment as being on or above their personal SML. This latter issue is particularly thorny given recent federal and provincial tax cuts, which have a tendency to diminish the appeal of tax credits. However, the blind pool or CED investment fund seems the most reasonable way to provide an exit route for CED investments at the present time.

9.0 Conclusions and Recommendations

In reviewing the vast array of background materials necessary to prepare this discussion paper, it has become clear that the concept of equity investing in CED initiatives is in its infancy. Although New Hampshire's program has been in place for nearly 20 years, its limited scope and its donation-based structure have prevented it from breaking new theoretical ground. The recommendations and conclusions that follow are therefore based on limited information and experience. For the equity investment question to be adequately addressed, additional and substantial research is necessary.

The following recommendations and conclusions include a number of suggestions for additional research programs. Many existing CED investment programs and government incentive programs have been put in place on the basis of incomplete information, which represents a danger not only for individual investors, but for communities who may suffer should CED investments come to be seen as poor risks.

However, while recommending further study, it is also clear that action should and can take place. The establishment of protocols, the carrying out of pilot projects, and the creation of a national structure to assist in delivering equity for CED to Canadian communities are worthwhile goals, and action to achieve them is possible.

9.1 A Study of Investment Returns and Appropriate Incentives

One of the fundamental difficulties in assessing equity opportunities in CED is the absence of reliable economic and econometric data upon which to base policy decisions. At the heart of this problem is the absence of real numbers to demonstrate historic rates of return on CED investments. Without being able to assess rates of return, it is impossible to place CED investments on the Security Market Line (SML), and impossible for individual investors to fully assess their investment opportunities.

Similarly, without this information it is impossible to identify appropriate levels of incentives. From an economic standpoint, the goal of an incentive is to raise the rate of return or lower the risk in such a way that the investment is at or above the SML. It is unclear whether the incentives currently used in programs across Canada are sufficient to achieve this goal.

Most provinces have followed each other, pied piper fashion, in offering a 30% tax credit for equity investment in CED ventures. However, as was demonstrated in Section 8.3.1, a credit of nearly 70% may be necessary to make CED investments "rational" and attractive to the investor. Similarly, many jurisdictions have offered limited investment guarantees, such as the guarantee of 20% in Nova Scotia. However, research in section 8.3.3 showed that even a 100% guarantee might be insufficient to bring CED investments to the SML.

While the numbers in this discussion paper are proxies for CED investments, the case for additional research on this question is clear. Indeed, to develop effective equity investment programs and strategies for CED in Canada, such research is a necessity.

9.2 A Study of Technical Assistance Options

The CCEDNet National Policy Forum in Vancouver in March of 2001 demonstrated that although there is high degree of interest in the equity investing concept, technical expertise on this topic remains restricted to a small number of individuals and organizations. At the same time, programs in New Hampshire and elsewhere have demonstrated the key role equity technical assistance can play in successful equity investment programs.

Furthermore, as demonstrated in Section 8.4, the availability of technical assistance can have a direct impact on a CED investment's rate of return, and therefore on the viability of equity investing in CED as a whole.

The Canadian Worker Co-op Federation (CWCF) has developed a specialized process of certification for technical assistance providers. Certification ensures that any work carried out on the technical assistance front is of sufficient quality for the CWCF Investment Committee to recommend investment. Furthermore, technical assistance is directly linked to future investment – every prospective applicant seeking investment must work with technical assistance providers in order to be eligible for that investment.

A range of CED technical assistance providers exists within Canada, including CCEDNet members, CEDTAP, RISQ and others. In formulating equity investment strategies and programs, it will be important to have a clear understanding of what technical assistance providers are available, and which are best suited to the provision of specific services or assistance.

To achieve this goal, it would be desirable to develop a database of technical assistance providers across the country. Although this database might grow over time, it is likely to be small at the outset.

9.3 A Study of Exit Routes and Strategies

As outlined in Section 8.5, the question of exit routes and strategies for CED investors is a significant one. Short of an initial tax credit, little consideration has been given to the investor's interest in the CED process. This reality threatens to undermine many of the existing CED investment projects in Canada, and will represent a major obstacle to any future efforts to establish more substantial or wide-reach CED investment initiatives.

A detailed examination of exit strategies for CED investors is necessary. If the larger CED community fails to adequately identify such exit routes, no amount of tax credits or other incentives will be able to encourage investment in even the most appealing and attractive CED projects. Without an exit strategy, investing in CED initiatives is akin to placing money in a bank and being forbidden from withdrawing it.

Although the concept of CED investment pools offers much promise, an in-depth study of the exit question will identify the full range of options, and include a variety of recommendations for policy and project development.

9.4 Equity Investing for CED Initiative

Despite a lack of relevant data, the opportunities for equity investment in CED represent a significant new model for empowering communities and building economic health and well-being. Although the research questions outlined above are necessary steps in moving forward, it is possible for CCEDNet and other CED organizations to move forward on the equity question in the short term.

The initial success of programs in New Hampshire and Nova Scotia, and the increasing interest in equity investment expressed by communities across the country suggest that the time is ripe for the introduction of a nationally-coordinated program focused on equity investment for CED. However, the Nova Scotia and New Hampshire models offer two fundamentally different approaches to addressing the equity question.

In New Hampshire, corporations make donations to the state government, which in turn uses these gifts to the benefit of communities. While this is an extremely worthwhile program, with much to recommend at the local level, it has very little to do with equity. It would certainly be worth exploring a similar model in Canada, but this should be recognized as an issue distinct from the question of an equity investment fund. The New Hampshire program essentially represents a corporate donation scheme, in many ways mirroring the way in which corporations may make donations to registered charities.

On the other hand, the Nova Scotia approach is a genuine equity investment model, as is the newly unveiled United Kingdom model with which it shares many features. By providing a genuine vehicle for equity investment, the Nova Scotia model offers a substantive and significant avenue to deliver new and important resources to Canadian communities. Donations (and for that matter, debt financing) have their place in CED, but as this paper has identified, there is a clear need for equity.

The potential exists for CCEDNet to act as the lead organization in a broader, multi-party coalition to identify mechanisms for the facilitation of equity investments in local, CED ventures and businesses. While much expertise exists at the provincial level, no national player has yet emerged to shape and direct the Canadian agenda on this issue. Furthermore, while organizations like CEDTAP may be well-positioned to provide expert advice and technical assistance across the country, no organization can match CCEDNet’s ability to reach directly into communities at the local level.

This ability to create a national vision while engaging in community-based action is ideally suited to moving the equity investment agenda forward. Equity investing as a concept requires a coordination of research and resources at a national level. To truly understand the implications of the equity process and the mechanisms necessary to its effective functioning, expertise from across the country will be necessary. At the same time, the ultimate goal of the equity investment process must be locally-driven. If a program to make equity investment practicable in Canada fails to understand the potential uses of equity at the community level, it fails completely. This reality is, of course, complicated by the fact that much of the relevant legislation and tax policy is set at the provincial level. Such a national-local dichotomy inevitably suggests a need for an organization such as CCEDNet to play the leadership role.

To this end, CCEDNet should undertake an initiative to move gradually toward the introduction of national equity investment strategy, culminating in the creation of a widely-available CED equity investment fund. The process for achieving this goal has five essential steps.

9.4.1 Step One: Establishing Protocols for Equity Investments in CED

It is necessary to recognize from the outset that equity investing is not a solution to all problems. Rather, it represents one tool in a larger CED toolkit. Issues from investment risk levels to necessary rates of return will ensure that only certain CED projects are appropriate targets for equity investment.

To this end, it would be advantageous for CCEDNet, or others interested in equity investing for CED purposes, to establish a series of protocols or guidelines for identifying suitable investment targets. Such protocols will require significant research an discussion, but could be based around the following principles:

1. Equity investments for CED purposes must demonstrate tangible benefits to the broader community
2. Ventures seeking equity capital must be based on sound business models, and have a reasonable chance of long-term viability
3. Ventures seeking equity capital must have a reasonable chance of generating a rate of return sufficient to attract investors' interest
4. Ventures seeking equity capital must be receptive to outside technical assistance and advice
5. Ventures seeking equity capital through a CED program should demonstrate that they have been unable to acquire necessary capital from more conventional sources

9.4.2 Step Two: Creating an Interprovincial Dialogue on Equity Investing for CED

To date, equity investment programs for CED in Canada have been coordinated at the provincial level, and have been largely based on the use of provincial tax credits. The development of a national strategy or program will therefore require close coordination between provincial interests. Although a federal program may be a possibility down the road, it will be easier in the short term to work within the existing framework, rather than attempting to create a new one.

Although not all provinces have a program to support equity investments in CED, most now do. While these programs are designed to be provincial in nature, the possibility of cross-provincial cooperation is real. The development of a national CED investment fund (CEDIF) could represent a significant opportunity to create a large pool of equity capital for use in those provinces which have CED investment programs in place. Although drawing on investments from across the entire country, this new CEDIF could file appropriate documents to ensure it complied with regulations of each participating province. Investors from those provinces would then be eligible to claim their respective provincial tax credits, with the contributions establishing a significant new source of capital for CED purposes. More details on how this new CEDIF could be structured follow in Sections 9.4.3, 9.4.4 and 9.4.5.

The end result of this Step is the creation of a national pool of equity capital for CED purposes, utilizing a range of provincial tax credits and incentives that already exist. The sheer size of the CEDIF, the provision of technical assistance, and the management role of nationally-respected body like CCEDNet are likely to make this approach attractive from a provincial perspective.

9.4.3 Step Three: Identifying Target Groups

In Section 2.2, a number of problems were outlined relating to the distribution of equity financing. In particular, it is obvious that women, first nations groups, rural and remote communities and some ethnic or national groups can be seen as disadvantaged by the normal flow of equity capital. As a result, it may be worthwhile to consider the establishment of a range of specialized national CEDIFs targeting these individuals.

This has the double benefit of correcting problems in the general flow of equity capital, and of focusing on specific target communities in a way that will differentiate the new CEDIF from existing provincial programs. The American New Market Initiatives effort has been focused in this direction, with early indications of success.

9.4.4 Step Four: A Regional Pilot Project

Having studied a number of outstanding issues, established investment protocols, brokered provincial buy-in and identified a series of target groups, the next logical step is to carry out a pilot project.

Based on information analyzed in Section 8 (and particularly in Section 8.5), the use of an investment pool or fund seems the most viable option for a successful equity investment strategy. It provides economies of scale by investing in multiple projects, can be marketed to a wider variety of investors, allows for greater discretion in selecting target investments, and provides some legitimate possibility of exit routes for investors.

Rather than establishing a national pool immediately, however, it will be important to demonstrate the viability of such an approach to equity investing for CED. The development of a smaller-scale, regional pool as a demonstration or pilot project allows fine-tuning of protocols and activities, and can help to leverage the buy-in of more reluctant partners. Interestingly enough, a community has already stepped forward to express interest in establishing such a regional pilot project.

In December of 1997, five Nova Scotia CED agencies sponsored a joint study to create a CED equity investment fund. The five agencies were:

- The Hants Regional Development Authority
- The Kings CED Agency
- The Lunenburg-Queens Regional Development Agency
- The Western Valley Development Authority
- The South West Shore Development Authority

Covering the rural regions of western Nova Scotia, these agencies proposed the creation of an equity investment pool to spur investment in their rural economies. Operating under the Nova Scotia equity tax credit program, the fund required a small initial grant or loan form external sources, but was designed to be self-sufficient within a relatively short period of time. The fund was to have been administered by a community-based professional staff.

The opportunity exists to rejuvenate this initiative, and use it as a demonstration project for a more ambitious national program.

9.4.5 Step Five: A National Program

The final step is to create a national model based on the results of earlier research and of the regional pilot project. At the heart of the national program would be the creation of a CEDIF, a targeted investment pool designed to enhance local CED initiatives.

Administered by CCEDNet, a national staff would:

1. Oversee the development of policies associated with fund operations
2. Oversee the commission sales of fund shares by selected financial advisors, and play a lead role in the promotion of the fund among potential investee companies, and individuals who may be future candidates for investment capital uptake
3. Carry out due diligence fund investment research where qualified to do so, and identify external technical assistance providers (CEDTAP, RISQ, etc.), fund managers or others who may be able to carry out such work where necessary
4. Act as an official secretariat to a Board of Directors, and carry out or cause to be carried out all decisions of that Board

5. Arrange for regular or periodic meetings of a range of advisory committees and panels, and ensure that they have the necessary resources and facilities to offer sound direction and advice to the fund
6. Act as a primary point of contact with government departments and agencies with an interest in the affairs of the fund, and with business and community representatives as appropriate
7. Make periodic visits to all ventures receiving equity investments form the fund
8. Identify situations where the fund should intervene with investee companies in order to provide technical assistance, and to make specific recommendations to the Board and advisory committees
9. Prepare timely reports, annual and otherwise, for the consideration of the Board and any government departments or agencies to whom the fund must report.

To carry out this role, CCEDNet would clearly need additional staff and financial resources dedicated solely to the provision of these services and the administration of the fund. Although the initiative would rely in many ways on provincial tax credits, it might also call upon a degree of federal funding to offset operational costs, particularly in early stages.

Given the generally low rates of return on CED investments, it is unlikely that sufficient revenues would be generated from the fund in its early stages to support a permanent administrative structure. However, given the positive impact of equity investments on the target communities and groups, it should be possible to make a strong case (perhaps to Human Resources Development Canada or a possible successor agency) for start-up funding. The 1997 western Nova Scotia proposal for an investment pool argued that a fund could be self-supporting within four years, and it seems reasonable to assume that the same could be true of a national program.

In the end, such a venture represents a significant undertaking, and has major ramifications for the organization assuming the lead role. However, it seems likely that if the necessary research can be completed, and the appropriate relationships can be built, significant new resources will be available to disenfranchised groups and communities across Canada. Although the task is daunting, the opportunity exists to make literally millions of new dollars available for renewing and revitalizing communities across Canada.

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