A Social Capital Market for Israel

Report of the Working Group
for Social Investment

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Summary

*A Social Capital Market for Israel* examines the field of social investment that has emerged in a number of countries, particularly in the UK and the US in recent years, and offers recommendations and ways to develop this field in Israel.

The nurturing of social investment in Israel would involve channeling more money to address social problems by improving the efficiency of financing by existing public and philanthropic resources, and by attracting new wealth to investments that offer twofold value: economic and social. We have learned from overseas models that the development of the field has potential to produce a quantum leap in contending with complex socio-economic challenges by reinforcing the financial strength of the main social services providers, and by making a positive impact on innovation and on the commitment to socio-economic outcomes and gains.

In recent decades, in the framework of government policy in Israel, work in many fields of social welfare, education and health has been transferred from the hands of the State - primarily to the hands of Third Sector organisations. In addition, social entrepreneurs who have identified gaps in responding to acute societal needs have taken upon themselves the mission of developing and operating new and diverse social services, such as assistance for special needs populations, women and at-risk youth, and in the fight against poverty and unemployment, among others.

In general, these organisations operate on a non-profit basis and naturally are unable to collect payment for the services they provide from the ‘consumers’ of these services. Their income – that is, the sources of financing for their activity – comes primarily from funding by the government and municipalities, which purchase services from them and support them in the framework of various support budgets, as well as from contributions and philanthropy (primarily from Diaspora Jewry).

Despite the fact that the efforts of social entrepreneurs and Third Sector organisations to address social problems generate clear socio-economic value in many fields, the prevailing approach to financing these efforts and the activity of non-profit organisations does not take these values into account. The result is that the social organisations are usually under-financed and often suffer from a lack of financial resources required for providing or developing social services – whether due to cutbacks in government and municipal budgets, organisational-managerial difficulties or the inability to rely on philanthropic funds (for example, because of global economic crises). Existing resources are also not always utilized efficiently, partly because of the forms of contracting with the government and the multiplicity of funding entities, with their various allocation mechanisms. In addition, many regulatory restrictions are imposed on the organisations, including limitations on developing sources of income from business activity that serves their social objectives, and this prevents them from developing independent sources of revenue. Due to this constellation of circumstances, the social organisations often experience
economic and financial difficulties, and lack adequate sources for their ongoing needs let along the needs of their development and growth.

The social organisations are indeed non-profit organisations, but their economic operation shares similar characteristics to those of a business that is required to provide services or products to its consumers. In Israel, however, these organisations contend with many more restrictions than those of a regular business, particularly in light of their special structure of revenues that creates the need for appropriate financing solutions. The approach proposed in this report is to learn from the methods developed in the capital market, which provide a solution for the financing needs of businesses, and to act accordingly to develop the social capital market in Israel.

As in the traditional capital market, in the social capital market there is also a supply side – the sources of finance, which today are primarily public allocations and philanthropic foundations, and in future may also include money from additional investors and institutional and corporate entities. On the demand side are the organisations that contend with the social problems and operate in a variety of organisational formats, as well as fields of significant preventive value, which require sources of financing in order to address issues such as affordable housing, juvenile crime, issues pertaining to public health, and so on.

However, the role of financial intermediaries that exists in the traditional capital market is absent in the social capital market. These intermediaries are the professional entities that know how to develop and enhance the sources of capital and adapt the supply of money from investors and savers to the companies’ demand for capital and credit, while developing appropriate financial tools of capital, credit and various combinations thereof. In the social capital market, these intermediaries are/might be called socio-financial intermediaries – entities with financial expertise that combines professional-management knowledge with an understanding of the economic needs of the social organisations for addressing social challenges.

While these entities scarcely exist in Israel today, socio-economic intermediaries have developed in recent years in other countries. There, with vigorous assistance of these intermediaries, governments have succeeded in bringing in ‘new money’ to the social fields from first-time investors – corporate, public and philanthropic, by developing innovative methods of financing and diverse financial tools. These intermediaries sometimes also work to develop the social organisations and improve their methods of operation, providing them with professional and management assistance and guidance. Socio-economic intermediaries are essential for the development of the social capital market because they can help in pooling the sources of supply, and enhancing and expanding the range of methods, as well as in adapting them to the needs of the social organisations and social fields that comprise the demand side.

It should be emphasized that the government, with its various regulatory agencies, is an invaluable player, without which the social capital market in this new approach cannot develop. The government should view these organisations as direct partners in contending with the social problems, and not merely as service providers. Therefore, it should work to change perceptions regarding the role of the various agencies that regulate and monitor the activity of social organisations. Its role is not only to create regulatory barriers against the misuse of public funds – but also to initiate, facilitate, remove obstacles, develop and enhance. Regulation can serve to foster the social organisations, enable them to develop additional sources of financing and help them to perform their important mission, on the one hand, and to cope with their limited resources, on the other. In short, the government can take action to develop an innovative view of financing efforts to address social challenges, and to ensure the strength and prosperity of the organisations that serve as the implementers of its social policy, in a manner similar to that which it pursues in order to ensure the prosperity of the business sector.
governments in developed countries have taken upon themselves the task of cultivating new sources and taking innovative approaches to meeting social challenges and assisting social organisations.

Following is a description of some of the main features of the social capital markets in the UK and the US, and of the nature of government involvement in these markets.

**The United Kingdom**
The British government adopted a large part of the recommendations of a special taskforce established in the year 2000 to study the use of practices from the capital market and entrepreneurship in order to contend with social challenges. The government’s innovative and creative approach is expressed in a number of ways, including: establishing financial institutions for community development aimed at increasing the accessibility to capital at the local level; encouraging investments by foundations and public entities in social financing and investment entities; and providing economic and tax incentives that benefit social organisations that conduct business activity.

**The United States**
In the United States, the Federal Government initiated special agreements that provide investors with incentives to invest in regions and fields that suffer from underinvestment. Government involvement in the social capital market in the United States includes a range of economic and tax incentives, including tax credits that encourage investment in affordable housing and community development; granting approval to philanthropic foundations to invest their funds at a lower yield when aimed at serving social objectives; legislation that permits non-profit organisations to issue bonds for financing activity serving a social or public objective with tax-free interest; allowing non-profit organisations to develop sources of income, as well as direct investments of the Government in Federal programmes that encourage social investments or social objectives with a range of incentives.

**Israel**
In the course of its study, the Working Group recognized that in addressing the salient social challenges of Israeli society, insufficient use has been made of innovative tools and methods that have been successfully tried in other fields (technology, for example). The Working Group is proposing the following recommendations as a basis for the development of a social capital market in Israel; if adopted, they would lead to the expansion of social resources, enhanced utilization of existing resources, and the further development of social organisations.

**First Recommendation: Establishing social investment funds**
Social investment funds – government or private – specialize in pooling money and professional investment tailored to the financing needs of social organisations, and can also improve the management of the organisations as part of the investment process. The Working Group recommends making efforts to develop such funds and encouraging the involvement of business and institutional entities as investors in them, together with philanthropic entities, and developing the tax incentives required for this. It also proposes that the government consider forming a government fund for social investments, on its own or in collaboration with other investors, with the goal of paving the way and encouraging the formation of private funds.

**Second Recommendation: Investing public funds in projects with social significance that yield economic returns**
Public money invested in pension funds and provident funds comprises one of the most suitable sources for social investment that yields long-term returns. The saving public would also profit from
the social benefit of such investments, which are aimed at addressing problems that hamper social cohesion. Since this involves utilizing the retirement savings of policyholders, it must be ensured that the money yields solid interest, as customary in the capital market. One way to do this is by spreading a governmental ‘safety net’ for investors, guaranteeing a return on investment at a rate specified in advance, similar to initiatives for developing investments in the fields of high-tech or the development of transportation infrastructure. Social challenges whose remedies require financing can also constitute an economic growth engine.

**Third Recommendation: Creating incentives for investment in social fields**

Social investment funds can expand the capital resources channeled to social fields and improve their utilization. But for this to happen, efforts must be made to modify the tax system so that investment in a fund would be recognized as a contribution, with all of the benefits this implies. In addition, innovative economic and tax incentives should be developed in order to bring money from the business sector into these funds, which would constitute an incentive for capital investment, similar to other fields.

**Fourth recommendation: Adopting an approach that encourages social-business corporations**

Social-business corporations have recently appeared on the Israeli landscape; the regulatory agencies have yet to recognize their special status as entities that work for a social objective but aspire to yield an economic return. In order for these corporations to be able to recruit investors interested in an economic return on their investment, a new type of corporation must be added to the Corporations Law – a corporation that works toward a social objective and is authorized to distribute a defined portion of its profits to its shareholders. Existing social corporations should also be permitted to develop business activity and, in particular, to develop sources of income that generate employment for marginalized populations. Currently, the tax system does not regard business activity of non-profit organisations as a legitimate way to generate income and imposes limitations or taxes on dividends.

The common denominator of these recommendations, and the condition for their successful implementation, is the understanding that the government has a central and exclusive role in stimulating change in the existing approach to financing the efforts to address social problems in Israel and the needs of social organisations. A government that believes in a developed welfare state should not only aspire to increase public spending, but should also act in innovative and creative ways to bring new players and involve all of the entities in the economic and social arena, with the aim of expanding and enhancing the resources required for contending with social problems.

The vision presented in this report is not as distant from us as it seems, and it could already be implemented in Israel now. The tools, the know-how and the accumulated experience already exist in various countries around the world, and in Israel too. However, in order to implement this vision, innovative economic thinking is needed by the government and decision-makers that sees both economic profit and social gains as essential for human welfare. Such socio-economic policy, in the spirit of the times, would work with the requisite creativity to mobilize new forces and additional economic resources for the benefit of the society as a whole, and in this way transform the problems of yesterday into the growth engines of tomorrow.
Introduction

In the last decade, Israel has enjoyed continuous economic growth, and since 2010 it has been considered a developed economy. However, the fruits of economic growth have not trickled down to all strata of the population. Along with accelerated growth, social gaps have grown considerably, stimulating a profound public discussion of the role of government and its responsibility for finding ways and budgets to contend with the numerous problems facing Israeli society.

Furthermore, the more Israel’s economy develops, the greater the demand for social services not previously provided to the public as a matter of course, from advanced preschool services to sophisticated services for the elderly. Meanwhile, new approaches advocate preventive measures to forestall the development of social problems in areas such as health, welfare, and crime prevention.

Moreover, as a consequence of the social situation, there has been a significant rise in the number of social organisations operating in Israel and the number of fields in which they operate. These organisations have undertaken diverse social missions in a variety of fields all over the country, addressing the different needs of Israel’s population and contending with the many social problems facing the country. Most social organisations in Israel operate on a non-profit basis. In recent years, in Israel and abroad, these organisations have been joined by ‘social businesses’, corporations committed to social causes as well as to profit.

Israel’s social organisations derive more than 50 per cent of their income from the government, and nearly 20 per cent of their activity is funded by various philanthropies, mostly those of Diaspora Jewry.1 Owing to the global economic crisis and other processes connected to the relationship between Diaspora Jewish communities and Israel, there has been a decline in foreign donations, along with an increase – although smaller – in local donations (by Israeli households and local businesses).

The limitation on financial resources available to Israeli non-profit organisations is a salient characteristic of their activity. Public allocations and philanthropic funds often cover only ongoing operations. As a result, social organisations constantly lack resources, and economic difficulties often prevent them from developing and providing important services.

In other countries the situation is similar: Governments and philanthropies allocate resources to contend with growing social problems, and the organisations confronting those problems suffer multiple difficulties.

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This situation requires fresh thinking and a discussion of important questions: Who is responsible for addressing social problems? Is it only the government, philanthropies, and civic organisations? Do social problems and challenges not concern all segments of society, including the business sector?

The answer to this question may be found in the emerging discourse of ‘corporate responsibility’, which has taken new directions in recent years both in Israel and abroad. This discourse focuses on the role of the business and financial sectors in contending with social problems in their countries of operation as well as in the world at large.

Until the 1990s, corporate social responsibility was reflected mainly in donations or volunteer activity. However, in recent years there has been a significant development in the discussion of corporate responsibility and the role of corporations in society. This new discourse may stem from the various financial crises and widening social gaps in Western countries as well as the poverty, hunger, and disease in the Third World.

There is a growing awareness that social ills concern all players in society and cannot remain the sole responsibility of the government and classic philanthropy. That awareness has been heightened by the resource constraints of both public budgets and philanthropists, especially with social gaps growing alongside economic growth in various countries.

The emerging discourse envisions a new world with no absolute dichotomy between corporations’ profit motive and social investment. Government, business, and civil society all seem to understand that the socio-economic optimum will not be achieved merely by combining public-sector activity and regulation with the ‘invisible hand’ of market forces (as envisioned by conservative economic theory). The renowned economist Michael Porter recently called for a change in the perceived purpose of corporations, recognising that their goal is to create shared value. He proposes that corporate shareholders and management broaden their view of the purpose of business: not only creating profit but taking responsibility for all stakeholders, including the corporation’s clients and the community as a whole.

In other words, corporations must not limit themselves to making money. They must reflect a multi-dimensional matrix of considerations with a far-reaching outcome including activity in innovative areas such as employee health along with economic and social investments that benefit their direct customers as well as society in general.

Meanwhile, an interesting process is occurring among Third Sector organisations around the world and recently in Israel as well. These organisations are beginning to discuss with their donors how to increase the effective impact of their activities. This requires that they adopt economic practises: Just like businesses, social organisations use the production means of labour and capital. Therefore, to achieve their goals, they must incorporate economic aspects and considerations, and guarantee their financial continuity and stability. In doing so they must optimise service delivery; manage their human resources properly, providing effective incentives; raise capital for development needs; and so on.

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2 Besides other issues in the discourse of corporate responsibility, such as preventing environmentally damaging investments and proper corporate management. See the introduction to chapter 3, ‘Impact Investment in the US’.


4 In this context we should mention paragraph 11a of the Companies Law 5759/1999, which states: ‘The purpose of a company shall be to operate in accordance with business considerations in realising its profits, and within the scope of such considerations, the interests of its creditors, its employees, and the public may be taken into account’.

5 These were the principles upon which the organisation Midot was founded, with the goal of promoting effectiveness as a main criterion in the matrix of considerations of social investors and non-profit management, by rating non-profit organisations and writing industry reports, in the spirit of ‘doing good better’. See www.midot.org.il.
This nascent approach to addressing societal challenges involves many questions. There are still no universally accepted models of optimal operation, methods of investment, ways of measuring social outcomes, and suitable legal and accounting tools for this new world. Progress is made partly by trial and error, but that does not detract from its importance.

The government has an important role in developing the new world. A government that advocates a developed welfare state must not only strive to increase public allocations; it must also act innovatively to attract new players and involve all elements of the economic and social arena in order to increase the resources needed to address social problems and optimise their use.

The developments described above are taking place in such advanced countries as the UK, the US, the Netherlands, France, Canada, Australia, and even Brazil. In the last decade, an important and compelling conversation has developed regarding how to increase resources and finance social causes. This conversation includes all sectors, and governments are playing a central role. In Israel, on the other hand, no such dialogue has begun.

In the aforesaid countries, the social realm is perceived as a challenge that should be confronted in new and creative ways because it has a significant impact on national growth and prosperity. Some countries see this field and its various players as a ‘new market’ that must be developed, particularly by the cultivation of new resources and creative ways of ensuring its growth. This new perception is reflected in the terminology chosen for this area: ‘social investment’ and ‘social finance’.

These new trends have given rise to task forces seeking to develop the new economic-social approach. One of the most famous and important is the Social Investment Task Force, established in the UK and headed by Sir Ronald Cohen. About a decade ago, the group published its socio-economic vision and acted to implement it, and the British government adopted most of its conclusions.

Since then, not only has the social-economic conversation about sources and ways of financing social areas changed, but so has the reality: New players have emerged, and specialised entities have entered the picture. Significant changes have occurred in the US as well as in Canada and Australia.

It is time to develop a conversation on social investment and social finance in Israel too, seeking new ways of cultivating financial resources and funding social causes.

This document has been prepared by a Working Group established with the help of Yad Hanadiv (the Rothschild Foundation). It aims to introduce the various players in the Israeli economy to social investment and social financing in several countries – mainly the UK and the US – and to offer recommendations for developing this area in Israel in keeping with the special structure and characteristics of its economy.

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8 See chapter 3, written by a Milken Institute team headed by Prof. Glenn Yago.


Chapter 1: The New Markets

What are social investments? What is social finance?

A social investment is a financial investment that takes into account not only economic return but social or environmental considerations. Social investment includes ‘socially responsible investment’ by corporations as well as ‘impact investment’, which is intended to improve society.

This report will focus on social investment – part of a broader world of ‘social finance’ – which uses various financing methods, usually supported by specialised financial entities that are familiar with the special needs of the social realm, with the primary goal of yielding social returns along with economic ones.11

A public conversation has emerged regarding the importance of social investments as a response to the activity of environmental movements, which developed the global discourse concerning the ability of market forces to address global social problems.

The concept of ‘socially responsible investment’ was created to distinguish between investments that contribute to society as a whole and ones that harm it. The parties who coined the phrase wished to discourage the business world from making investments that harm the environment or society, and they did so by denouncing ‘non-social’ investments by a process of screening.

In recent years social investment has assumed a much broader meaning, including ‘positive’ investments in society and not only the avoidance of negative ones. As the American ‘Forum for Sustainable and Responsible Investment’12 says: ‘SRI investors encourage corporations to improve their practises on environmental, social, and governance issues’.

The field currently includes two additional kinds of investment: One is the result of economic crises and has to do with investment in companies that maintain proper corporate governance, which is not the subject of this report. The other concerns investments that contribute to society, including needy, ‘disempowered’ communities. These investments are the focus of this report.

The Forum explains the practical applications of social investments:

Putting money into underserved communities as an investment strategy that remedies economic disparity by providing lower-income people with access to capital, credit, and training that they otherwise would not have. Community investing is beyond charity and is a sound investment practice. These investments earn competitive returns, like non-community development investments, but also produce a social return that is attractive to investors and helps communities in need.

11 We would like to include in this definition all investments with a defined social goal, regardless of how their economic return compares to that of an equivalent investment.
12 http://ussif.org/.
The purpose of developing awareness of social investment is to increase the resources devoted to social causes. This means not only increasing government and philanthropic allocations but also developing investments by the business sector and institutional entities, such as pension funds, which invest public funds for the long term and increase their share of investments that produce both economic and social returns. With this kind of investment, the business return or yield can be measured alongside a measurement or other presentation of the social return or yield, and sometimes the environmental return or yield as well. Accordingly, investors of this type present not only the usual profit line but also the social return – producing a double or triple bottom line.

As this conversation about social investment develops, Western governments are seeking new ways of expanding social services provided to citizens by increasing social investments. That increase is achieved partly by encouraging private investment – business and institutional – and improving the use of philanthropic money to solve social problems while developing the financial resources of the social organisations dealing with these problems.

There has been a change in philanthropy as well. There is a growing awareness that the traditional allocation of philanthropic funds, via donations and grants, cannot achieve maximum social outcomes and, mainly, does not suit social organisations’ financing and development needs. As a result, traditional foundations have begun seeking investment options that can increase their social impact, including investment methods that endeavour to help social organisations develop a solid economic model for their activities. The US government was the first to recognise the need to incentivise large philanthropic foundations and invest their capital – not only the return or interest on their principal – in achieving social goals. Hence the inclusion of additional concepts in the term ‘social investment’: ‘program-related investment’ and ‘impact investment’.13

**Social investments and social finance**

In this report, the term ‘social investments’ has another important meaning, which is to increase and diversify the investment methods and financing instruments available to social organisations and to develop mechanisms to address social problems. The capital constraints in social fields are more severe than in many other areas, because the ‘consumers’ of social organisations, the recipients of social services, can never bear their full costs. Therefore, while increasing the level of social investments, we must also develop diverse investment tools and financing mechanisms in order to optimise use of the various resources – public, philanthropic, and business – to meet the financing needs of social organisations and develop new ways to contend with social problems.

The following diagram illustrates how a combination of capital resources from different investors can increase the amount of capital for social investments by combining investors whose main goal is social (philanthropic funds), who are sometimes also interested in financial return, with financial investors, who want a real return.

13 These concepts are explained in chapter 3.
Sir Ronald Cohen, a founder of venture capital in Europe and a pioneer of social investment in the UK, considers it very important to develop unique and innovative financing mechanisms and create professional players who specialise in investment mechanisms and making capital accessible to social projects. He believes a multiplicity of investments and financing mechanisms is vital for the increase of resources to address social problems and to encourage social organisations and entrepreneurs to develop coping mechanisms. As he says: ‘The supply of money will create its own demand of social entrepreneurs.’

**Why are social investments and social financing important for Israel?**

Israel has shown constant and impressive economic growth in recent decades. However, data from the Bank of Israel, the World Bank, and the OECD show growing economic disparities between the centre and periphery of the country and between different strata of society as well as different communities and groups. As a result, social problems are developing and worsening in many areas, threatening the social fabric and solidarity that characterise Israeli society. Not surprisingly, this problem is not unique to Israel. In other thriving Western countries as well, geographic and social enclaves are isolated from economic growth and suffer from severe social ills such as poverty, unemployment, violence, and crime.

Israel has a large and active civil society (32,000 registered non-profit organisations, of which 25,000 are active) working to respond to society’s diverse needs in many areas, such as education, youth-at-risk, violence prevention, and health. The growth rate of non-profits in Israel is 7 per cent per year (1,700 new organisations), the financial volume of their activity is estimated at NIS 98 billion (as of 2010).
2009), they produce 5.9 per cent of the GDP, and they account for 16 per cent of Israel’s private and public consumption and for 369,000 jobs (excluding volunteers).15

In the past decade, there has been a significant change in government policy: Operational responsibility for welfare and social services has been transferred almost exclusively to Third Sector organisations providing services and support budgets. For example, the following figures indicate the large extent of services purchased from non-governmental bodies by the Welfare Ministry:

### The Purchase of Services from Non-Governmental Bodies by Central Departments of the Welfare Ministry (2004)16

<table>
<thead>
<tr>
<th>Department and Social Services</th>
<th>Main area</th>
<th>Level of purchase of services from non-governmental bodies out of department budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Department of Rehabilitation</td>
<td>Disabled care</td>
<td>93%</td>
</tr>
<tr>
<td>Department of Care for the Mentally Retarded</td>
<td>Care for the mentally retarded</td>
<td>72%</td>
</tr>
<tr>
<td>Department of Personal and Social Services</td>
<td>Care for children, youth, and the elderly</td>
<td>96%</td>
</tr>
</tbody>
</table>

Though the activity of non-profit organisations creates clear socio-economic value in many areas, these bodies are usually underfunded and often lack resources needed to deliver or develop social services, whether because of cuts in national and local government budgets or because of organisational-managerial difficulties or inability to rely on philanthropic funds.17

These professional organisations are vital for addressing Israel’s social challenges, and they work to create a social profit that is ‘distributed’ throughout society. They may be non-profit, but they function much like a business. That is the light in which we must examine the resources available to them, their financing needs, and the financial mechanisms that ought to be at their disposal, compared to those that exist today. Diverse financing methods, instruments, and mechanisms must be developed that resemble those available to the business sector but reflect the special characteristics of social organisations. Such an economic and financing analysis is required if these organisations are to realise their goals and maximise their beneficial impact on society as a whole.

An analysis of Israel’s financial resources indicates that it differs from other countries. The following figure18 was presented at the 2010 Caesarea Conference by a team headed by Dr. Nissan Limor, which examined the needs of Israel’s civil society and Third Sector. Among other recommendations, the team called for developing a philanthropic capital market and creating diverse financing tracks for non-profit organisations.

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16 Source: State Comptroller, , 2005, 55b. We assume for the purpose of this paper that the level of purchases has risen or remained the same.

17 Like the 2008–9 economic crisis, which required government intervention through a NIS 100 million emergency aid fund.

18 www.idi.org.il/events1/CaesareaForum/Pages/Civil_Society.aspx.
These figures indicate a substantial difference in the level of self-generated income as a source of funding for Israeli non-profits and for foreign ones. The difference stems, among other things, from the recognition in advanced countries of the need to allow social organisations to develop self-generated financial resources in order to reduce their dependence on donations or government allocations. The increase of social organisations’ financing sources may also help them develop their financial, strategic, and organisational management.

Countries with active social organisations are keenly aware that a new approach is needed to deal with the financing problems of these bodies and the communities in which they operate, which would apply tools and concepts from the fields of investment, business, and even venture capital investment. This approach sees in ‘underinvested’ communities, organisations, and social areas the potential for economic and social growth, and treats them as new markets.19

The development of these markets, just like others, requires investors and capital, whether by philanthropic or business investment or by credit access. Just as important, new players are needed: professionals who can develop the areas of social financing and the financial tools and means to optimise allocation of capital resources. The traditional sources in the social arena are governmental and philanthropic allocations, but these are not enough. Therefore, creative ways to increase resources must be found in order to increase social investments. The overall answer is to develop a ‘social capital market’.

The vision: a social capital market in Israel

The economic behaviour of a social organisation is much more complex than that of an ordinary business: Its income does not come from the recipients of its services, because the recipients of social services cannot afford them. As a result, these organisations need constant outside funding, and the development and enhancement of sources of funding requires special thought.

19 See ‘Growing the Social Investment Market: A Vision and Strategy’. This government report summarises a large study that sought to identify barriers and draft recommendations for developing a social capital market in the UK. www.cabinetoffice.gov.uk/resource-library/growing-social-investment-market-vision-and-strategy.
This raises the question: Why not develop financial sources and mechanisms similar to those of the classic capital market? Given the knowledge and experience gained from the development of the capital market, its players, and the diverse instruments they have devised, can we harness that to benefit those who need social-economic returns so badly? Why not develop a ‘social capital market’ whose (social) profits will serve Israeli society?

The attempt to apply an economic approach and seek capital sources to solve social problems is rooted in the belief that in other markets as well, as in the economy as a whole, there are resource constraints, including on capital resources. The development of the capital market eased these constraints through specialised players who developed diverse investment channels and financial infrastructures, combined with specialisation and proficiency in business management and innovation. Thanks to the development of the capital market, capital resources and ways of investing them have also grown and improved, thereby contributing to the growth of businesses and the development of the economy at large.

A good example is the growth of the investment funds and especially the venture capital funds which significantly increased investment in technology and high tech. These funds typically raise and pool capital from varied and diverse investors (including institutions), while developing administrative proficiency and investment methods based on managerial-professional knowledge, leading to impressive growth in these sectors.

In an analogy to the structure and processes that transformed the capital market, and the field of high tech in particular, we believe we must develop growth engines in an area some consider ‘very low-tech’ as well. We must offer innovative ways and means of developing ‘social capital markets’, which will enhance the use of existing resources and increase those available for financing social issues and social organisations, while developing financial-social specialisations and professions.

Based on what is happening in Israel and abroad, we believe we must increase capital resources for social goals by means of judicious use of the capital resources of philanthropy, business, and the institutional world, while developing financing tools. These tools will create the conditions for local economic viability and facilitate an economic solution to social problems and the needs of social organisations. Professional entities specialising in financial mediation and social consulting could help construct the tools and means necessary to invest these capital resources in communities and social organisations suffering from underinvestment, with the expectation of both social and economic returns.20 These means will attract new sources of investment to areas requiring preventive action, such as crime, school attrition, and similar social problems, whose reduction has measurable economic as well as social benefits. In other words, when we can measure and evaluate outcomes in social areas, we can present investment in them as bearing social as well as economic returns. Put simply, if social activity has a measurable or assessable social and economic value, it is investable.

This novel approach does not mean to downplay the importance of the existing resources for dealing with social problems, nor does it seek to replace them. Rather, it is based on their existence and wishes only to develop social-economic solutions.

The development of ‘new markets’ requires a new way of thinking – shared by all players – and, mainly, a systemic combination of the public, philanthropic, business, institutional, and social sectors. The idea is to create economic opportunities and increase resources for addressing social problems; a joint effort

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20 The economic return may be lower but could also equal the equivalent return of another solid investment in the capital market – such as the return on government bonds – if it is combined with tax incentives.
by all parties will allow the creation of new capital resources and the realisation of each party’s primary interests, while creating social value and yielding an economic profit for social investors.

This vision has already been realised. For the last two decades, it has been emerging and applied in developed Western countries such as the UK and the US, and it was recently also adopted in Canada, Australia, and some members of the EU. We believe it is time to develop and apply it to Israel. To that end, we will now explain the thinking behind the idea of the ‘social capital market’, review what is happening in the UK and the US, and then examine the situation in Israel.

From capital market for business to social capital market

Let us try to describe how to develop a ‘social capital market’ and what its components should be. To do so, we will first describe briefly and generally the structure of the capital market, emphasising the Israeli version. The capital market contains a variety of players, who fulfill a series of vital roles:

On the demand side are the companies, which manufacture products and supply jobs, and need capital for their growth and development. The companies turn to the capital market to raise the money they need. First they go to the banking system for credit; then they go to other channels, which can be roughly divided into two kinds: raising capital, which entails investment in exchange for shares; and raising credit, debt, which means receiving a loan from the public by issuing bonds. There are additional ways to raise capital through a variety of financial instruments, such as options or mechanisms combining capital and credit. All of these – shares, bonds, and financial instruments – are securities, and most are traded on the stock market, the regulated trade arena of the capital market. Companies with a significant volume of operations can sometimes raise capital outside the stock market, directly from institutional investors, who invest the public’s funds for the long term.

On the supply side are the sources of money in the economy: saver and investor funds. A few investors act directly and buy securities from companies on the stock market, but most of the public’s money is invested in capital markets through professional ‘financial intermediaries’, who act according to investors’ preferences for short- or long-term investments. For our purposes, these are the players who provide financial infrastructures and tools that bridge and mediate between investors and companies. The banking system works the same way, because the public funds deposited in banks are lent to companies.21 This discussion will include among the capital market players the financial intermediaries, the banking system, institutional investors, investment bankers, the various capital funds, and others.

The financial intermediaries are professional bodies that create diverse investment methods and financial tools providing for the needs of investors and companies. On the one hand, they understand companies’ funding needs and know how to provide for them, while on the other hand, they understand investors’ desire to receive an economic return on their investment. Thanks to their professionalism, they know how to match appropriate ways of raising and investing capital while adjusting the investment to the investor’s risk preference. Furthermore, financial intermediaries pool the economy’s capital resources, which are the public’s money.

Financial intermediaries also include such specialised investment funds as venture capital funds, private equity funds, and investment banking. These intermediaries specialise in certain kinds of investment and develop a thorough knowledge and understanding of the companies in which they invest. Their involvement contributes significantly to the operations and effectiveness of these companies, in terms

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21 Of course, the banking system also provides credit to households and medium and small businesses, which, as a whole, lack access to capital market sources.
of both manufacturing and management. Their expertise is also recognised by institutional investors, who invest long-term savings in these funds, expecting them to yield higher returns. In the last two decades, these specialised entities have made an important contribution to the growth of companies in the areas of communications, high tech, and more.

In other words, financial intermediaries know how to develop and enhance capital resources and match the supply of investor and saver funds to companies’ demand for capital and credit. Without them, the capital market might not exist.

Other players in the capital market rate, measure, and monitor the various companies that raise money in the market, using that information to inform investors about these firms’ financial resilience. In this respect, the Israeli capital market typifies most developed capital markets.

What drives the players in the capital market – companies as well as investors – is the desire for profit. This ‘engine’ drives company efficiency and growth.

Regulators also play an important role in the capital market. They identify market failures, including player failures; establish and enforce laws and mechanisms to deal with those difficulties; and make the market as competitive as possible. For example, the Securities Authority ensures that investors have reliable information on which to base their investments in the securities offered on the market; in addition, the Authority monitors the players through which the public acts, such as trust funds and portfolio managers.22

The following figure describes the various players in the capital market and the relations between them:

An Effective Capital Market: ‘Introduces’ Savers and Investors to Firms and to Sources and Vehicles of Financing

22 Although in recent years there have been many crises and failures in the capital market that regulation did not always address, including on the global level, that does not negate the market’s importance; its problems must be solved on the local or global level.
This array of players is vital to any capital market, including the social capital market. We shall now look at the players operating in the social markets, identify their needs as well as the missing financial infrastructure, and discuss the role of the regulator in these markets.

The characteristics of the social capital market

The players in the social and capital markets need not be identical; however, both markets seek to increase the capital resources available for investment and to diversify the means to that end. In the case of the social capital market, capital resources are meant for investment in social issues and for the development of the social organisations dealing with them.

What drives the social capital market is the double bottom line – the social and economic return on the investment. Obviously a double bottom line is more complex than maximising economic or social profits alone. Needless to say, it is also harder to measure a double bottom line than a classic profit/loss line.

Nonetheless, the challenge must be met. In our world, governments, businesses, and social corporations are all part of a matrix of economic and social players whose actions affect each other and society at large. Business managers must take ‘corporate responsibility’, constantly weighing the value that their decisions create against the economic, social, and environmental damage they cause. The academic and public discussion of these issues is particularly lively today, and the world’s leading academic institutions – such as the top business schools in the UK and US – are deeply involved in it.

The following chart presents a model for a social capital market in Israel:

A Social Capital Market: An Innovative Approach to Funding Civic Organisations
On the demand side of the social capital market are socially oriented ‘companies’, especially non-profit corporations of various kinds. In Israel, the latter are called; in the UK, for example, there is greater variety. Most of these corporations provide social services to particular communities or populations. Another innovative, challenging type of company on the demand side operates for profit while pursuing social goals. This kind of ‘social enterprise’ is new to Israel and not yet significant here, but a wide variety of such businesses has existed abroad for more than a decade. These social companies or ‘social enterprises’ which are entities that develop independent sources of funding, include firms that operate in order to realize social objectives while making profit. In Israel, social enterprises are beginning to emerge; they are encountering significant legal and tax issues – while in other countries, social enterprises that have sprung up over the past decade are flourishing and even earning the support of their respective governments.

Though Israel has only two kinds of corporations, the Committee for the Examination of the Roles of the Third Sector in Israel and the Policy towards It (2003), headed by Prof. Yitzhak Gal-Nur, distinguished four types of organisations in the Third Sector: those providing services integrated with the public system; those providing services on a contractual basis; organisations engaged in social, communal, and civic activity; and agents of social change. For our purposes, it is clear that on the demand side we will find mainly the first two types of organisations, whose economic activity is more obvious, but other kinds of organisations should not be excluded from this discussion.

An analysis of the demand side, describing Israel’s social organisations, can be found in papers by Dr. Nissan Limor, the Israel Centre for Third Sector Research at Ben-Gurion University of the Negev, and the Centre for the Study of Philanthropy in Israel at The Hebrew University of Jerusalem. The various social organisations operate in complex economic circumstances. They must constantly worry about raising the external resources they need for their activities in order to guarantee their continuity and development, but unlike businesses their revenues do not come from consumer purchase of their services. Therefore, raising ‘revenues’ is a daily chore. Often these organisations spend considerable resources on fundraising, so they cannot allocate the resources necessary to develop professional administration infrastructures, which are no less important for the activity of a social organisation providing vital services. Social organisations are dreamt up by their founders, but their viability and success require administrative and economic knowledge. There is a critical need for players to help these organisations acquire managerial and professional proficiency.

In Israel, as elsewhere, a multiplicity of organisations commonly operate in the same area for the same purposes, but without structured cooperation between them. Such cooperation could enhance the services provided in areas such as youth-at-risk, support for women, and so on. Indeed, a social intermediary has emerged in the UK to enhance the activity of organisations and the delivery of services.

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26 See, for instance, Dr. Nissan Limor, ‘Barriers and Lack of Infrastructures that Inhibit Realisation of Third Sector Organisation Potential in Israel’, Civil Leadership, November 2008; and Osnat Hazan, ‘The Relationship between Governemental Funding and Private Funding of Third Sector Organisations’, November 2009, the Centre for the Study of Philanthropy in Israel, Hebrew University of Jerusalem.
27 A new organisation in Israel, Kimron, is devoted to just that task. See www.kimron.org.il
This organisation coordinates social services, thereby creating an economy of scale in competing for tenders.  

On the supply side, the side of the investors, are the capital resources: mostly public allocations and philanthropy. These sources provide their funding in various ways: 

In Israel, the public budget provides for social services either directly, such as through the education system, or indirectly (and more broadly), through the welfare system, where services are purchased mainly from social organisations and usually by annual contracts. Likewise, funding is provided through the support budgets of the government ministries and local authorities, which are also usually annual and may change every year according to criteria determined by the ministries and their ministers. It is doubtful that the government officials who employ these means of funding see them as ‘methods of investment’ aiming to achieve social returns, although surely this funding has social goals. It is equally important to ask whether there has been any study of the effectiveness of the allocations to the various social organisations in achieving their goals.

In philanthropy the motives and means of funding are different. The main motive for the investment of philanthropic capital is the desire of the donors, including the philanthropic foundations funded mainly by donors from abroad, to assist and support the development of solutions to diverse social problems. Philanthropic donations are also temporary, and the donor either cannot or does not desire to guarantee long-term funding.

In general, what both types of traditional social investors have in common is short- and medium-term funding that is usually not conditional on a pre-defined or measurable outcome, and certainly includes no expectation of an economic yield. Furthermore, the traditional social funders do not necessarily request an accurate report on the use of their donations and the extent of their impact, nor do they seek to measure or assess the social yield. One reason is the difficulty of measuring social effectiveness and yields in a clear, standard manner. However, though the funds in question are philanthropic, the donation is an investment, which must be guaranteed to achieve its goals – whether because often the money comes from corporations investing funds they would otherwise distribute to their shareholders, or because the donors are receiving tax benefits because of their donation. This is all the more true when it comes to government funding.

Treating the funding of social areas as a social investment requires discretion and choosing between alternatives, but mainly the monitoring, reporting, measurement, and assessment of the investment. The issue of effective measurement of investments and the use of tools to assess the ‘Social Return on Investment’ (SROI) has been addressed comprehensively in the last decade, including by philanthropic foundations. The British government got involved in this issue two years ago, working with

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28 The organisation is called the Social Investment Business. See www.thesocialinvestmentbusiness.org
29 Except for donations for the construction of buildings and the like.
30 Unless it is for contracts in a tender to provide specific services, where the size of the population receiving the service is pre-defined.
31 See the discussion of these issues by the Global Impact Investing Network: www.thegiin.org/cgi-bin/iowa/reporting/index.html.
social organisations and accounting experts to develop uniform measurement tools with which to audit social impact and reporting.33

Israel is beginning to contend with questions of effectiveness,34 but no significant progress has been made on the measurement and evaluation of social and welfare areas.35 Although most resources on the supply side come from state budgets and donations, that does not detract from the importance of talking about tools and means to measure and evaluate the social impact of these funds. Such tools are necessary to develop the social capital market, because only with them can the social yield of an investment be displayed alongside its economic yield in order to recruit additional investment in social areas. Therefore it is vital to develop these tools now in order to create a functioning social capital market in Israel.

The social financing experts that adjust supply to demand are a new player that exists abroad but not in the Israeli social capital market. We shall call them, in an analogy to the capital market, ‘social-financial intermediaries’. These entities specialise in funding combined with professional management knowledge and understanding of the economic needs of social organisations. These parties have undertaken to bring ‘new wealth’ to the social sphere by innovating means of financing and diverse financial instruments in order to recruit different kinds of investors for the appropriate funding of social organisations and the addressing of social problems in innovative ways. Along with funding social organisations, these players have also undertaken to provide professional-managerial assistance and direction to social organisations. These entities develop an understanding of social issues and sometimes even encourage social organisations to merge in order to realise their goal more effectively and receive appropriate funding. These players are critical for the development of the social capital market, because they can help pool resources on the supply side and tailor them to the needs of social organisations or areas on the demand side.

In the UK and US, a special kind of financial intermediary has emerged in the social markets, which has developed special financing methods and recruited the business and institutional sectors to invest in them (in addition to the philanthropic foundations and government), thereby increasing sources of social funding and using them effectively. This has given rise to social investment and financing funds: the first ones belonged to large philanthropic foundations, and were followed by specialised investment funds combining money from different sources as well as social banking (more on this in the next chapters). These players are necessary for the development of a new method of funding social needs and the organisations that deal with them, and they scarcely exist in Israel today.36 The simple reason is that the main investors in the social markets – the government and philanthropies – have not yet recognised the importance of diverse means of financing or of the ability to develop financial instruments geared towards social issues.


34 See note 5 regarding Midot, an organisation promoting the effectiveness of non-profits and donors in Israel; and see the work of Sheatufim in developing social management proficiencies: www.sheatufim.org.il/managers.aspx.


36 Several Israeli philanthropic foundations employ advanced means of allocation and funding, but we are familiar with only two foundations that attempt to pool donors in order to establish a fund for investment in and funding of social enterprise projects: the Dualis Israel Venture Fund (http://dualis.co.il/) and the Israel Venture Network (www.ivn.org.il/).
According to this new approach to developing the social capital market, another crucial player is the government, with its various regulators of social, economic and tax issues. The government must see social organisations as its direct partners in grappling with social problems, and must therefore redefine the role of the various bodies regulating and monitoring organisational activity. Aside from creating regulatory barriers to abuse of public funds or non-profit corporations, their role is to take initiative, facilitate, remove obstacles, develop, and enhance; they must develop social organisations, allow them to cultivate additional sources of funding, and help them contend with their important role on the one hand and their resource constraints on the other. In short, the government must develop an innovative philosophy of funding social areas and organisations.

Having outlined some of the principles and theory underlying the social capital market and social investments, we shall now describe and review the progress that has been made in the US and UK, present approaches and models that might indicate possible directions of thought and implementation, examine how the concept of the social capital market developed in those countries, and review the foundational steps in the process. Finally we will return to Israel, examining its unique characteristics and recommending measures that can be taken to pursue the establishment of a social capital market.
Chapter 2: The United Kingdom

A social investment market supported by intensive government involvement

The accelerated growth of social investment in the UK began with the establishment of a task force to address the country’s burning social issues. Headed by Sir Ronald Cohen, the Social Investment Task Force examined those problems from a new socio-economic perspective, attempting to adopt and apply principles from the world of investment in general and venture capital in particular, and submitted to the British government a concise report with a series of recommendations. Most were soon accepted and implemented, thereby paving the way for a decade of developing financial instruments, organisations, and models of innovative and original action in a joint effort of the social, business, and public sectors. The Task Force continued to monitor developments in the field and publish periodic reports. Ten years after publication of the first report, the team published a summary report reviewing the market that had developed in the UK and highlighting its players and instruments as well as offering programs and ideas for the future.

Social investment in the UK includes a variety of active players. Despite changes of government and the financial crisis, the government still plays a paramount role in shaping the market and its incentives, as well as being an active investor. The government also serves an important function as an investor and potential capital resource.

In reviewing the situation in the UK, we shall first point to the main measures taken by the government and the recently published recommendations for the future. Then we will review the other prominent players in the field.

Measures undertaken by the British government to develop the social investment market

Establishing financial institutions for community development and funding (CDFI) and offering a tax benefit to investors

The Social Investment Task Force identified a critical barrier to tackling social problems on the community level: the lack of access to capital on the local level, ie, the absence of funding entities that...
could remove the barriers to the granting of loans to small businesses, social organisations operating in the different areas, or residents interested in initiating and participating in local renewal. The report pointed to the need to develop local financing entities, which would be licensed and specialise in community development in a variety of areas, especially by granting loans or unique capital investments. The government accepted the Task Force’s recommendation and approved a legislative arrangement to establish such entities. In addition, tax benefits were provided for investors in those institutions, to incentivise the business and philanthropic sectors to invest the capital needed for their activity.

The entities in question, Community Development Financial Institutions (CDFI), are based on a model developed in the US.41 To develop capital resources for the activity of these entities, and pursuant to the Task Force’s recommendations, a tax benefit was offered to those investing in them: a 5 per cent cumulative credit for five years – making for a total of 25 per cent. That tax benefit led to the establishment of twenty regional financing entities managing £60 million.42

Granting additional incentives for the development of social investment and financing entities

The Social Investment Task Force found also barriers to the investment of capital funds by philanthropic foundations. As of the Task Force’s first report, British law did not allow philanthropic foundations to invest in social projects or in the new social financing entities (such as the community financing organisations), whether they were non-profits or hybrid social capital funds operating to create profits for their investors, about which we shall elaborate below. Because of these restrictions, endowment funds43 avoided investing in social purposes. Instead, they put their money in banks or the capital market, investing only their earnings on these investments – usually about 5 per cent of the total fund – to provide grants and donations to ‘classic’ social organisations, namely non-profits such as charities, which are the equivalent of and non-profit companies in Israel. According to the Task Force, this meant that substantial capital resources, namely the foundations’ own capital, were not maximised socially or economically. Therefore, in the absence of economic incentives and due to regulatory constraints, the funds sought no additional methods of investment. That is why suitable professional financial intermediaries did not emerge – entities specialising in developing ways to invest the foundations’ resources and unique means of financing tailored to the needs of social organisations and socially oriented businesses.

The Task Force recommended lifting the regulatory constraints and allowing the foundations to invest their own resources. That recommendation was also accepted by the government, and public organisations dedicated to public causes – such as philanthropic foundations and the British equivalent of Israel’s lottery – were allowed to invest not only in banks but also in social financing and investment

41 See chapter 3.
42 The government had hoped to raise more money this way, and in its last report, in 2010, the Task Force enumerated the barriers to the development of the financial entities and offered a series of suggestions for removing these obstacles. See ‘Social Investment Ten Years On’, p. 10.
43 In the world of philanthropy there is a distinction between two kinds of funds: an expendable fund, all of whose money is used for providing grants or donations; and an endowment fund, whose donors intend to continue operating it for years and therefore invest its money and use only the profit on their investments – the interest or other profits – to provide grants and donations.
entities, as long as their corporate instruments did not forbid them to do so. In other words, a philanthropic foundation is permitted not only to invest its endowment in the traditional financial markets or donate some of its accumulated yields to social causes, but also to invest — both from its endowment and from capital gains — in entities specialising in social investments, in the expectation of a financial and social return. Thanks to that agreement, and another one published more recently, in the last decade large philanthropic foundations have been investing part of their endowments in the community financial institutions described above and in specialised financial institutions established to advance social goals.

The Task Force’s last report, summarising the past decade, found that the current challenge is to bring in additional capital resources from the business sector and especially from long-term-savings entities — the institutional entities — and invest them in social areas. These entities manage very substantial sums of free capital for investment. Investing even a fraction of that in meeting social challenges, with economic returns being a higher priority than social returns, could bring about a dramatic and significant social change.

Creating a basis for the existence of social enterprises, and taking steps towards their development

Regarding social investment in the UK, the government has taken a remarkably innovative position, expressed in a comprehensive report from February 2011, ‘Growing the Social Investment Market: A Vision and Strategy’. The report reflects the belief that a variety of social enterprises must manufacture independent sources of income in order to fund their activities in social areas. Therefore, it is important to develop suitable sources of funding and diverse financial instruments for them, including by way of economic incentives.

Says the report (emphases added):

Britain is blessed with inspiring social entrepreneurs driven by a desire to improve the lives of their fellow citizens. They lead organisations bent on finding sustainable solutions for entrenched social problems. These organisations are social ventures — and it’s time to get behind them.

This policy is evident in recommendations that additional economic and tax incentives be developed to benefit social organisations which run businesses. In its conclusions, the report reviews the existing barriers, with the government undertaking to lift them and monitor the success of the various incentives in stimulating economic activity by social organisations, and in attracting new investments and players, so the British social capital market can continue to thrive.


46 Examples of such foundations are the Portland Trust, the Sainsbury Family Charity Trusts, and the Esmée Fairbairn Foundation.

47 See ‘Social Investment Ten Years On’.

48 See note 19 above.

The UK social capital market: the main players

In the past decade, various kinds of players have emerged in the field of social investing in the UK. To map the social capital market, we will first describe the forms of association of the main players on the demand side, then note the new financial intermediaries that have emerged, and finally review the main parties on the supply side.

The demand side: social enterprises in various forms of association

The UK has several kinds of enterprises working to achieve social goals. The most familiar kind are charities, the equivalent of in Israel; they operate in traditional ways, based on donations. Alongside them, the last decade has seen the emergence of social enterprises – a general term for a variety of social corporations operating in a business format. Social enterprises aim to achieve social goals by business and economic means. These entities focus on income-generating business activity, whether as the central way to achieve their goal or as an external source of income enabling the organisation to carry out its various activities while guaranteeing its viability and reducing its dependence on governmental or philanthropic funding. The UK has a large variety of social enterprises as well as appropriate government regulation of tax benefits and other incentives to stimulate their activity.

For instance, there are organisations that help disempowered populations – such as by developing businesses to employ them – or operate stores or other commercial activity to create income for themselves. Sometimes the business is not fundamentally related to the organisation’s social goal, but the income is meant to expand and improve the organisation’s social activity. In these cases the organisation’s financing needs are similar to those of a regular business seeking to development. For example, the organisation will need funding to rent a building and buy raw materials and equipment to operate its social business. In the UK, methods have been developed to allow organisations to receive suitable financing, not only as a donation or grant, but also as a loan, an investment or a combination of the two.

Social enterprises incorporate in various ways: in the traditional manner, as charities; as limited corporations; or as a new corporation, as detailed below. The choice to set up a limited corporation is usually made by enterprises whose business activity is central, such as those opening factories to employ excluded populations that suffer from lack of access to the labour market. These populations (youth-at-risk, people with disabilities, or the chronically unemployed) also need, in addition to jobs, special help and support in the framework of their employment.

To facilitate the development of social-business enterprises, the British legislature created a new kind of corporation suitable for the new social world: the community interest corporation. This limited corporation, whose bylaws establish its social goals, may distribute up to 30 per cent of its profits to shareholders. This kind of corporation and its shareholders are considered ‘small businesses’ and enjoy incentives identical to those given similar businesses. Meanwhile, corporations of this kind are

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50 One such organisation is Bikeworks (www.bikeworks.org.uk), which defines itself as a social enterprise and is incorporated as a limited corporation in the new model described below. This organisation has developed a whole system of social enterprises to employ excluded populations. Another example is Shelter (www.shelter.org.uk), which is incorporated as a charity and operates a chain of gift shops whose revenues constitute 15 per cent of its income.
supervised by a regulatory agency, which ascertains that they are indeed acting according to their declared goals.\textsuperscript{51}

The social enterprises in the UK are characterized by various types of incorporations described in circles 1–4 in the following illustration,\textsuperscript{52} enable them to develop a variety of businesslike activities in order to contend with social issues. Though they sometimes operate according to different legal and economic models, they all need an adequate financial basis, sources of funding, and income to ensure their existence and development.

The figure below\textsuperscript{53} (describing the British situation) illustrates the spectrum of organisational models, from charities (the equivalent of ) – all of whose income is based on fundraising – through various kinds of social businesses, to regular commercial enterprises operating for profit without any social mission.

The organisational models above differ in their purposes, ranging from social to economic, but circles 1–4 all allow new kinds of financing in addition to traditional funding solely by donations. For example, organising as a limited corporation is meant to enable capital investment by investors interested in receiving dividends on their investment in the corporation’s shares. Incorporating also facilitates the receiving of loans and mortgaging of assets, but it does not entitle the corporation to tax breaks on donations. On the other hand, a business not geared towards the distribution of profits does not allow capital investment. If such a corporation needs financing to develop its ‘business’ operations, it may

\textsuperscript{51} According to the 2004 Companies (Audit, Investigations, and Community Enterprise) Act. See also ‘Investing in Social Enterprise’.

\textsuperscript{52} Israel lacks the diversity of organisational models described in this illustration.

\textsuperscript{53} Venturesome, ‘Financing Civil Society’.
obtain this funding ‘normally’, principally by securing credit or loans, as well as via a novel royalty agreement, developed to enable the financer to earn more than interest on his investment.54

Financial intermediaries

As in the traditional financial markets, in the social capital market the meeting between the capital and the business or social venture requires financial intermediaries with a deep understanding of both sides of the market: supply and demand. But in the social capital market, they must also be well versed in the various social areas.

The social financial intermediaries know how to match capital resources to a social organisation’s developmental stage and repayment capacity. At the organisation’s start-up stage, it needs ‘seed money’ to build or develop the foundations necessary for providing its various services, including purchasing assets, equipment, and buildings, computer and administration infrastructures, assistance with accounting, publicity, marketing, and so on.55 In its second, operative stage, the organisation requires ‘operating capital’, and it sometimes needs additional financing from banking institutions as well to contend with cash-flow difficulties. The third stage is that of development and growth, requiring investment in the development of services and products that will enable the organisation to grow and develop the knowledge or products needed to improve its activity and increase profits.

Therefore, social enterprises’ financing needs resemble those of regular, for-profit businesses. However, given their social objectives, social enterprises have less access to financing than ordinary businesses, and it is harder for them to obtain funding with reasonable terms. This disadvantage hinders the development of social services and has created the social-economic need to find them appropriate financial solutions. The role of the financial intermediaries in the social market is to analyze the operations of the social enterprise and its sources of income, help it professionalise, and match it with diverse and combined investment sources. These intermediaries must bridge the gaps between investors and social enterprises while pooling the various resources and designing appropriate financing solutions to help these organisations do their important work.

The following illustration depicts the financing needs of social enterprises56 and the appropriate sources of their repayment capacity. The vertical axis presents the accepted funding mechanisms, and the horizontal axis defines the economic risk for the investor; the ellipse represents the match between funding mechanisms (supply) and needs and risk. The illustration shows that the greater the risk – namely, little repayment ability – the better for the social enterprise to seek traditional funding, such as grants and donations. On the other hand, the greater the repayment ability, the better to obtain funding from the ‘regular’ market.

54 Venturesome is a social investment fund that has developed a funding agreement for corporations forbidden to distribute profits. The arrangement resembles a royalty agreement, in which the funder is entitled to royalties in accordance with business development.

55 According to Israeli tax laws, a long-term investment to finance the development of the infrastructures of social enterprises is not necessarily recognised as a donation if the investor is entitled under certain circumstances to a return on his investment.

56 Venturesome, ‘Financing the Big Society’, September 2010. The figure demonstrates how different investment mechanisms are available to provide capital appropriate to its use and risk profile (the shaded area represents the zone of appropriate funding).
In the new world of the social capital market, the financial intermediaries are responsible for finding, matching, and designing the financing needed by the social enterprise; they develop the professional and administrative support for these enterprises and know how to identify and pool the capital resources they need to realise their goals; and they specialise in finding solutions for the financing and funding needs of the organisation as well as creating and designing the appropriate financial products to raise funds from the various investors on the supply side, considering their risk preferences and desired returns.

In the past decade, a variety of social financial intermediaries have developed in Britain, which we shall now review.

‘Ethical’ or ‘social’ banking

This category includes ‘social’ banks, which mainly lend to organisations dedicated to social purposes.

The most prominent of these banks is the Charity Bank.57 Created by a joint initiative of the government and philanthropic entities, this bank, as its name suggests, helps provide loans to organisations that work for social purposes, especially non-profit organisations and social enterprises. The bank is supervised like any other, though it is registered as a charity and – like a public interest company – does not distribute profits to shareholders. While the bank must follow the same capital adequacy rules as other banks, it need not achieve capital gains for its investors and therefore can operate at profit margins that regular banks cannot. The bank’s main activity is providing loans to social organisations at lower interest than commercial banks would charge. Sometimes the bank asks the social organisation for securities against the organisation’s assets to guarantee loan repayment. The bank enjoys no direct government subsidy, but most of its deposits are made by the government, public bodies, large philanthropic foundations, and – recently – individuals interested in social investments. In 2010, the bank lent an estimated £138 million.

57 See more about the Charity Bank at www.charitybank.org/.
Other social banks in the UK are permitted to distribute profits to shareholders. One such is Triodos Bank,\(^\text{58}\) a commercial bank that specialises in extending credit to organisations with a social and moral agenda. Its depositors want their money to serve social purposes and therefore agree that some of their deposits will carry lower interest than that offered by a regular commercial bank.

**Social investment funds and social financing funds**

These funds invest in social organisations or provide them with financing in various ways. The funds can be divided into two kinds: philanthropic financing funds, and financing funds that yield profits for investors, which include social venture funds.

Philanthropic financing funds are more common. Investing in these funds are philanthropic investors or philanthropic funds, primarily large philanthropic foundations. Instead of investing in banks or investment funds that operate in the business world, these investors invest in a professional social investment fund that specialises in providing financing solutions for social organisations. These funds are sometimes called venture philanthropy.

The other kind of social investment fund, which has grown and developed in recent years, is for business investors interested in social investments that yield economic returns. These funds see their goal as developing new resources for the social realm, or bringing ‘new wealth’ into the world of social investments, which gives investors a double bottom line – economic and social returns.

The two kinds of social investment funds can also be characterised by their investors’ investment goals: The first kind’s primary objective is to yield social returns (impact-first investment). Investors in these funds wish to receive a financial return on their investment but are willing to accept a lower one than they would have received from a mainstream investment, as long as the stated social goal is achieved. The primary objective of the second type is to yield a financial return equal or close to the market return (finance-first investment). Investment in these funds sometimes carries a higher risk, but investors are willing to take that risk in order to receive a higher financial return along with social impact.

**The Social Capital Market**

\[\text{Source: Monitor Institute (2009), Investing for Social and Environmental Impact}\]

The first kind of fund, whose main goal is social impact, includes financing funds established by large philanthropies in order to develop financing tools for the social sector. One of the leading funds in this area is Venturesome, established by the large Charities Aid Foundation, which specialises in designing financing solutions and tailoring them to the needs and abilities of social organisations while developing their economic capacities. Venturesome also publishes valuable resource material about financing social organisations.

Venturesome provides financing to social organisations that cannot distribute profits because of their corporate structure (such as charities). This financing is to be returned to the fund with a profit by way of an interest-bearing loan or other mechanisms. According to one model developed by Venturesome, the organisation pays a kind of ‘royalty’ on the fund’s investment. Despite its ‘business’ activity, Venturesome is still essentially a philanthropic fund and takes into account a variety of financial and social considerations when making its investments. For instance, the fund can take financial risks in order to achieve social goals, such as by providing an interest-bearing loan to finance a socially significant project with an especially long-term repayment schedule spread over an especially long period.

The following figure compares Venturesome’s financing mechanisms to those of other social investors. The green diagonal line represents the investment expectation of ‘commercial’ investors, and the line below it represents the investment expectation of social investors, which may be lower. The difference between them represents the financial yield that the social investor is willing to sacrifice in order to create social impact.

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59 For further information about Venturesome’s financing of non-profits, see http://caf-venturesome.tumblr.com/more.

60 Usually in order to overcome the prohibition of profit distribution.

The second kind of fund invests investors’ money with the goal of yielding economic profit along with social impact. These funds usually focus on social enterprises, businesses that operate for social purposes and distribute profits.

Differing from philanthropic investment funds, this type of fund appeals to additional investors: Its declared goal is to yield the same return earned by a solid investor in the capital market, but by means of investments that realise social goals. These funds specialise in investment in areas and businesses involving social causes defined by the fund or in areas on which the fund focuses and for which it raises money from various investors.

One well-known company that manages this kind of fund is Bridges Ventures, an investment firm founded by Sir Ronald Cohen. The firm’s vision:62 ‘Bridges Ventures is a sustainable growth investor whose commercial expertise is used to deliver both financial returns and social and environmental benefits. We believe that market forces and entrepreneurship can be harnessed to do well by doing good’.

Bridges Ventures manages three main kinds of investment funds: social venture capital funds; funds that invest in special real estate assets in excluded areas slated for renewal, and in green and sustainable construction; and funds that invest in social enterprises and seek to achieve a high social impact along with a solid financial return.

The first fund managed by Bridges Ventures was established with a government and philanthropic capital investment of £40 million. The second was established solely by philanthropic funds and business investors, at twice the volume of the first fund. The money of the first fund was fully invested and yielded a relatively high return. The investment created significant economic leverage in the areas where the fund operated.63

The funds managed by Bridges Ventures boast impressive social achievements.64 Their money was invested in for-profit companies whose activity embodied a social value in which the fund was interested.65 The fund’s reports note that the invested capital helped hire 1,370 workers, 250 of whom had been unemployed; 40 per cent of these workers were hired in what the British government defined as deprived areas at a high priority for renewal, and thirty-three of the thirty-four entrepreneurs came from such areas;66 and 60 per cent of the investments were channeled into geographic areas defined as extremely problematic economically and socially.

In general, social venture capital funds do not enjoy special tax breaks or other unique benefits. However, the initial investment in them was made by the government on special terms in order to encourage investment by philanthropic and institutional investors and prove the model’s feasibility. In the initial investment, private investors enjoyed a clear advantage: They received a return on their investment, in addition to the profits it yielded, before the government received a return on investment. The government took the main risk only in the first fund: After the investment model proved itself, government support was no longer needed to raise the capital for the second fund. But some investors in the second fund were philanthropic funds.

63 The fund estimates that every pound it invested added £2.1 of product to the investment area.
64 www.bridgesventures.com/results.
65 For examples of the investments of funds managed by Bridges Ventures, see www.bridgesventures.com/node/177#harlands.
Social investment funds exist in other countries as well and are common in the US, as will be detailed below. Some focus on investment in the country in which they were established, and others invest in developing countries.67

‘Private’ banking that specialises in social finance

The best example of this kind of specialised player is Social Finance, another organisation founded by Sir Ronald Cohen. This professional financial entity aims to address social problems directly while pooling resources and developing novel financing tools. One such tool is the social impact bond, which represents a new approach to investment in preventing social problems.68

This tool is based on the assumption that there are social problems whose prevention would lead to significant budgetary savings but require a substantial financial investment; the government cannot invest the resources necessary to prevent these problems, though it needs to allocate budgets to treat them.

The model is based on the fact that some investors are willing to invest in developing ways of preventing a social problem, risking the failure of these investments, and in exchange the government will share with these investors the budgetary ‘profit’ if the efforts to prevent or considerably reduce the problem and the budgets needed to contend with it succeed. The risk for investors is high, but the profit they stand to gain if these efforts succeed is greater than that afforded by a similar investment in a solid channel.

The government benefits considerably: It bears neither the cost of the prevention program nor the risk of its failure. The government ‘gains’ the investment of resources outside the budget in the attempt to prevent the problem, and if the attempt succeeds, the profit embodied by the budgetary savings is divided between the investors and the government in a pre-determined way. The government need only that portion of the budget that was already allocated. Furthermore, everyone enjoys the budgetary savings once the problem has been dealt with.

Social Finance conceived of this ‘social impact bond’, which is now in progress after the investors who were recruited signed a special agreement with the government, to be described below. The first area where this model is being implemented is crime prevention, particularly recidivism. This area was selected because it is one of the gravest social problems in the UK, and the government has resolved to confront it. The assumption is that most ex-cons return to crime, and therefore prisoner rehabilitation is a primary social goal whose achievement would prevent the expansion of the cycle of crime. Rehabilitation would also represent significant budgetary savings, from prison expenses up to those of the law enforcement and justice systems, the welfare system, and so on. However, rehabilitation requires considerable resources, and its success is proven only years later, so public savings are not achieved immediately.

Recidivism prevention is a good example of a social issue that requires a social venture capital investment: It is a high-risk investment of a large sum of money over considerable time, which, if successful, can yield significant budgetary savings in many areas and achieve an important social goal.

Social Finance established the first fund to invest in social impact bonds dedicated to prisoner rehabilitation. The Government and the fund drew up the parameters for the program’s success and the ways

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67 For a list of social investment funds throughout the world, see http://compassioninpolitics.wordpress.com/2011/03/28/list-of-top-social-investment-funds/.

68 See details at www.socialfinance.org.uk/sib.
of measuring any budgetary savings it would create. In exchange for the investment, the government pledged that if the rehabilitation succeeded at the end of the prescribed period, the investors would receive their investment back plus a profit in the form of a portion of the amount saved by the state budget as a result of the criminals’ not returning to crime. That amount would be calculated by means of a pre-determined formula, including expenses saved by the prison service, the justice ministry, and the budgets of other key government ministries. The investors, for their part, undertook to finance the full cost of the rehabilitation, taking the risk upon themselves. If the intervention succeeds, each investor will receive his share depending on the amount of his investment.

The profit for the government and for society is both economic and social: The government saves the investment in prisoner rehabilitation and passes the risk on to the investors; if the intervention works and the payment goes out, both the government and society ‘gain’ the important social outcome of crime prevention, along with whatever portion of the budgetary savings the government does not pass on to the investors, as specified in their agreement.

The role of the social investment banker (in this case, Social Finance) in designing this innovative financial instrument is very complex: On the one hand, it operates on the financing level, consolidates resources and investors, and constructs the financial and contractual package; on the other hand, it is responsible for developing the rehabilitation program and for its successful execution. The rehabilitation model focuses on a group of prisoners serving sentences of less than one year, monitoring them over a four-year period. Working with social experts, Social Finance developed the program, which would be operated by social organisations specialising in that area. In other words, the social banker identified the investors, pooled the resources, contracted with the government, and is also responsible for the operation and success of the rehabilitation program. Thus, Social Finance managed to design a very innovative way of financing the treatment of a social problem at the critical stage of prevention.

**Social Impact Bond Structure**

![Social Impact Bond Diagram](image-url)
The economic model of social impact bonds can be implemented in numerous social areas that require a clear prevention plan for which measurable benchmarks of success can be defined and the economic profit of whose success can be quantified, such as the budgetary savings of preventing negative social phenomena.

This novel mechanism for financing the treatment of major social problems by acting at the critical prevention stage has attracted great interest in different countries. Even the president of the United States recently announced the allocation of $100 million to develop seven programs of this kind, namely prevention programs combining diverse sources of funding (including philanthropy), with returns dependent on outcomes.69 The state of Massachusetts is also considering introducing social impact bonds.70

Public banking for social investment: the social investment ‘bank’

The Big Society Bank is a player that has not yet emerged. The Social Investment Task Force recommended establishing it more than a decade ago, and the British government decided to do so recently.71 This investment bank will pool financial resources that do not currently serve social investments, and its capital will be composed mainly of dormant accounts, commercial bank investments, and a contribution by the Big Lottery Fund. The bank will also have a fund permitted to receive donations from philanthropic investors. The goal is to reach £600 million in seed money – £400 million from dormant accounts and £200 million from commercial bank investments.

The bank’s vision is to serve, using diverse investment mechanisms, as a sort of public investment bank and as the leading investor in the British social capital market, by virtue of its status as an investment bank with substantial capital. One proposed mechanism is investment in social investment funds, which serve as ‘social intermediaries’ in the British social capital market, by making the initial investment in the fund, or by way of investment in deferred capital in conjunction with investments emanating from the commercial and institutional sectors. Another possible technique involves perfecting investment in social enterprises by developing capital resources for long-term investments in the development of infrastructures for these organisations. Another way is for the bank to underwrite or guarantee investors in social impact bonds to be issued in the future.72

The proposed structure of the Big Society Bank is meant to guarantee independence and professionalism in the development of novel forms of investment in social areas. Though the bank has not yet been created, the very decision to establish it as well as the government capital the British prime minister has allocated for its activity reflect a new approach for the British government: The government is the main party undertaking the development of the social capital market through diverse instruments and the allocation of appropriate resources in order to stimulate the treatment of social problems in innovative ways.

In conclusion, a review of the development of the British market in the last decade indicates that the previous and current governments attach tremendous importance to the development of a social capital market with a variety of players and investment channels, and see it as a critical way of contending with social problems and guaranteeing thriving social enterprises.

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We mentioned above the comprehensive report published by the British government, ‘Growing the Social Investment Market’. The introduction to the report articulates the importance of developing a social capital market to address the country’s growing social needs:

Our vision is to create nothing less than a long-term ‘third pillar’ of finance for our crucial social ventures, alongside traditional giving and funds from the state. This pillar of finance is social investment, money that blends financial returns with social returns.

The report presents a broad vision of how to address complex social issues as well as develop social organisations by new means of financing. The role of the government is key. It must serve as the founder of the social capital market by lifting regulatory barriers and granting economic incentives. For Israelis, reading the report is like visiting another universe, where new financial, economic, and legislative means are constantly being sought to contend with social problems, through the development of business enterprises which serve as a vanguard in the struggle.
Chapter 3: Impact Investing in the US

Closing academic achievement gaps, replacing greenhouse-gas-emitting technology with renewable energy, improving health-care services, and expanding capital access to low-income Americans for housing and business start-ups – these are just a few of the United States' many goals in the years ahead. Funding these solutions, however, is far from easy.

The public and philanthropic dollars available to address these issues are inadequate, leading to a demand for more opportunities for private-sector investors to participate. Impact investing – actively investing in such a way as to achieve a financial return and create a positive social and/or environmental impact – channels more funds towards public policy solutions while allowing private-sector investors to achieve their financial goals. Building on a long tradition of philanthropic involvement in meeting social challenges in the US, interest in impact investing has grown as the financial crisis has underscored the reality of limited funds and the magnitude of our social and environmental challenges.

While the impact investing industry is still relatively nascent in the United States, options exist across asset classes to pursue these investments – in alternative investments, fixed income, equities, and hybrid instruments. The federal government has continued encouraging the expansion of philanthropic activities to innovate and adapt to current challenges through its regulations and programs. Different types of investors, from pension funds to foundations to individuals, can find investments that suit their risk and return appetites while rigorously maintaining fiduciary responsibility.

This chapter focuses on the changing role of the US government in the development of financial resources for the non-profit sector, the types of tools and techniques that have been used to leverage private dollars for social purposes, and the rise of innovative approaches efficiently combining public and private resources to meet the growing demand for social investing.

History

Although impact investing is a relatively new approach, the concept has deep roots in American history. Those roots are planted in a tradition of charitable activities and civic associations, as noted by Alexis de Tocqueville in his observations of American society in the 1830s. He noted that this tradition of 'voluntary associations', with individuals and communities contributing time, effort and money to various causes, including the American Revolution just fifty-five years earlier, reinforced the philanthropic and...

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74 This chapter was written especially for this report by staff of the Milken Institute: Glenn Yago, Jill Scherer, Steven Zecher, and Alma Gadot-Perez.

75 Alexis de Tocqueville, , 2 vols. (1835–40).
democratic development of the American character. Furthermore, once the US Bill of Rights formally separated church and state, support for private education (which was largely religious) and religious institutions required philanthropic initiatives. Today, this independent, non-profit sector is huge and growing, with incentives for wealth transfer towards public and social needs. Public charities report $1.4 trillion in revenue and $2.6 trillion in assets, while private foundations report $181 billion and over $621 billion, respectively, and other non-profits, $386 billion and more than $1 trillion.77

Early in US history, it became common practice to combine social causes with charitable giving, devoting time and money to private initiatives for the public good. For example, in its earliest form, what later became known as ‘socially responsible investment’ (SRI) consisted mainly of avoiding ‘sinful’ activities or businesses. The Quakers, for instance, forbade their members from participating in the slave trade, so they avoided enterprises, products, and activities involved in slave labour, trying to influence social behaviours through economic actions.78 Major social movements, such as those focused on women’s suffrage, abolition of slavery, civil rights, conservation, and antiwar efforts, started with a similar socially responsible investment philosophy.

With the industrialisation and growth of the nineteenth century, the charitable landscape in the US resembled that of other developed societies. Wealthy benefactors such as the Rockefellers, Vanderbilts, and Carnegies dedicated substantial portions of their assets to ‘giving back’ to their communities by building and endowing schools, universities, hospitals, libraries, and cultural resources. These landmark charitable gifts were fueled largely by huge capitalist successes among these industrialists, unaided by federal tax policy. Indeed, until the early twentieth century, the US had no fixed personal income tax.

Figure 1: Timeline of Major Federal Initiatives and Socially-responsible Investment

Source: Milken Institute, 2011

76 In the First Amendment. The Bill of Rights was ratified in 1791.
78 In 1673, Quakers published ‘An Exhortation and Caution to Friends concerning the Buying or Selling of Negroes’, the first anti-slavery tract circulated in the American colonies. See www.qhpress.org/quakerpages/qwhp/gk-as1693.htm.
In 1917, the federal government introduced a tax deduction for charitable contributions. As incomes rose and wealth became more widespread in the US, these tax benefits provided an important economic bonus to a much wider community of American families.

As shown in figure 1, the US experience highlights the intersection of broad democratic, social commitments and individual economic activities to influence social outcomes. Historically, philanthropy was born of government limitations on the funding of private and religious activities and, eventually, was expanded through the government’s use of taxation to leverage innovative beneficial investments in order to meet these social needs.

The Social Investment Forum estimates that socially responsible investing (SRI) now totals $3.1 trillion in the US – more than 12 per cent of the country’s total assets under management. Given that this estimate reflects only one component of impact investing, the total of socially responsible investing is much greater.

Today, SRI encompasses a range of strategies, including positive and negative screening (incorporating environmental, social, and governance [ESG] factors into investment decisions); shareholder advocacy (filing shareholder resolutions on ESG issues); and impact investing (direct investments in entities producing financial and social and/or environmental return), the upcoming focus for investors and philanthropists.

**Federal Government’s Role in Developing the Impact Investment Market**

In support of these beneficial investments, the US federal government has created regulations and products that provide investors with the incentive to channel capital into underserved domestic markets. Examples of these public policies are presented below.

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• **US Income Tax Deduction.** The US Internal Revenue Service (IRS) permits a tax deduction for charitable giving\(^{80}\) by individuals and corporations. This deduction allows individuals and corporations to reduce their taxable income, thereby reducing their marginal tax rate and tax liability. For the top income tier, figure 2 shows that the estimated tax liability can be lowered by 22 per cent (from 9.5 per cent to 7.3 per cent).

**Figure 2: Estimated 2010 Income Tax Liabilities for Selected Average Incomes**

(based on average itemized deductions)

<table>
<thead>
<tr>
<th>Without Charitable Contribution Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
</tr>
<tr>
<td>Contributions</td>
</tr>
<tr>
<td>Total Itemized Deductions</td>
</tr>
<tr>
<td>Net Taxable Income</td>
</tr>
<tr>
<td>Federal Taxies</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
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</tbody>
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<table>
<thead>
<tr>
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<tr>
<td>Federal Taxies</td>
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<tr>
<td>Effective Tax Rate</td>
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</tbody>
</table>

Source: Milken Institute, 2011

• **Program-related investments (PRIs).** PRIs are concessionary investments made by foundations to support charitable activities. As part of the Tax Reform Act of 1969, Congress created a legal definition of the term for private foundations. PRIs can be counted towards their annual required 5 per cent payout if the primary purpose is to advance their charitable objectives, production of income or appreciation of property is not a significant purpose, and funds are not used to lobby or for political purposes. Otherwise, these investments will be treated as

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\(^{80}\) Section 170(c)(2)(B) of the Internal Revenue Code provides that, for the purposes of section 170, the term ‘charitable contribution’ means a contribution or gift to or for use by a corporation, trust, community chest, fund, or foundation organised and operated exclusively for religious, charitable, scientific, or education purposes or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.
a taxable expenditure and subject to an excise tax. Foundations, thus, can make PRIs as an alternative to grants.

While PRIs are generally in the form of below-market loans to qualifying organisations, they can also be equity investments and credit guarantees as well as market-rate loans to private entities. An appealing aspect of PRIs is that unlike grants, funds can be recycled, extending the philanthropist’s reach. PRIs can also be made by foundations that extend beyond the 5 per cent payout requirement, but the investment must be made at ‘commercially reasonable’ market rates of return. These investments further the foundation’s social aims while maintaining its fiduciary role in the management of its assets. Further discussion of PRIs can be found below.

- **Community Reinvestment Act (CRA).** This federal law was passed in 1977 in recognition of the fact that financial institutions were sometimes passing over loan candidates from low- and moderate-income neighbourhoods. The CRA was designed to encourage commercial banks and savings associations to meet the credit needs of borrowers in all segments of their communities. Financial institutions are monitored for CRA compliance and are required to complete regular CRA exams. Federal regulatory agencies take this information into account when making decisions about the opening of bank branches and about mergers and acquisitions, making compliance with CRA requirements very important in the era of the growth of interstate and global banking.

- **Tax credits.** Tax credits lower the taxes paid by individuals and businesses. Two examples that affect impact investments appear below.

  » **Low-Income Housing Tax Credit (LIHTC).** LIHTC was created as part of the Tax Reform Act of 1986. The credit provides an incentive for private equity investments in the development of affordable housing, offsetting the equity amount by the amount of the tax credit and thereby boosting the return on equity for investors. Tax credit syndications, selling the tax credits for a project to groups of passive investors, have been instrumental in attracting equity investments in ‘hard-to-finance’ projects in distressed communities. From 1987 through 2008, the federal government issued approximately $10 billion in tax credits, leading to the creation of about 1.8 million units of affordable housing.\(^{81}\) Since the financial crisis, demand for LIHTC has decreased in tandem with corporate profits; however, the market has begun to recover.

  » **New Markets Tax Credits (NMTC).** The NMTC program was created as part of the Community Renewal Tax Relief Act of 2000. It provides investors with a seven-year, 39 per cent income tax credit for making equity investments in certified community-development entities, which invest the capital in economically distressed or low-income communities. Figure 3 illustrates a typical investment scenario and annual returns of approximately 8.6 per cent per year (5.6 per cent of which is due to NMTC). The federal government has awarded a total of $26 billion in NMTC since 2000. In fiscal 2010, community-development entities made approximately $3.5 billion in NMTC investments, primarily in real estate projects, which created or maintained approximately 58,000 jobs.\(^ {82}\)

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\(^{82}\) Ibid.
Figure 3: Example of Estimated Returns with an NMTC on a $1 Million Investment in a Community-Development Financial Institution

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Eligible CDFI</td>
<td>1</td>
<td>1,000,000</td>
</tr>
<tr>
<td>New Market Tax Credit</td>
<td>1 to 7</td>
<td>39%</td>
</tr>
<tr>
<td>Credit Taken</td>
<td>1 to 3</td>
<td>150,000</td>
</tr>
<tr>
<td>Credit Taken</td>
<td>4 to 7</td>
<td>240,000</td>
</tr>
<tr>
<td>Credit Value Available</td>
<td>1 to 7</td>
<td>390,000</td>
</tr>
<tr>
<td>Average Annual Return on Investment From Credit</td>
<td>1 to 7</td>
<td>5.6%</td>
</tr>
<tr>
<td>Additional Estimated Average Annual Returns on Investment From CDFI Activity</td>
<td>1 to 7</td>
<td>3.0%</td>
</tr>
<tr>
<td>Average Annual Return on Investment</td>
<td>1 to 7</td>
<td>8.6%</td>
</tr>
</tbody>
</table>

Source: Milken Institute, 2011

- **Qualified section 501(c)(3) (non-profit) bonds and other private activity bonds.**

  Private activity bonds were first enabled by legislation in 1968 to make loan capital from private investors available to non-profit organisations, for-profit entities that serve a public policy purpose, or hybrid organisations constituting a form of public-private partnership. The government issues the bonds but is not responsible for repayment. Repayment is linked to the business model and revenues of the project. The non-profit or for-profit or public-private borrower is liable for generating the pledged revenues at this lower cost of capital through the bond market. Like most municipal bonds, interest is tax-exempt. As a result, as shown in figure 4, interest rates are lower than for conventional banking products, making these bonds an attractive low-cost alternative for non-profits. Prior to the financial crisis, which greatly reduced all securities issuance, the private activity bond market had grown to $132 billion in 2008, and the US 501(c)(3) (non-profit) bond market stood at $86.4 billion. By 2010, the crisis – and the fiscal crisis of municipalities and states – had reduced the dollar volume to $74.2 billion for all private activity bonds and $46.6 billion for 501(c)(3) bonds.

  Hospitals, colleges, and universities were initially the primary beneficiaries of these bonds, but they are also used to finance child-care facilities, among other non-profits and public-private partnerships. Other forms of private activity bonds have been used for health, social and environmental facilities, low-income single- and multi-family housing (especially for first-time buyers), small businesses (for working capital and capital expenditure), urban and regional redevelopment, and student loans.

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83 Section 501(c)(3) of the Internal Revenue Service Code describes corporations, trusts, and associations organised and operated exclusively for charitable and other exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

The US government also makes direct investments and guarantees to generate positive social impact. Examples include:

- **Community-Development Financial Institution (CDFI) Fund.** This Treasury-run program was established in 1994 by the Riegle Community Development and Regulatory Improvement Act and promotes economic revitalisation and community development by investing in and assisting CDFIs. Congress makes annual appropriations to the CDFI Fund, which has provided $1.3 billion directly to CDFIs and similar organisations.85

- **New Markets Venture Capital (NMVC).** The US Small Business Association (SBA) manages the NMVC program, which was launched in 2001 to support companies making venture capital investments in low-income areas of the US. Six NMVC companies have been certified by the SBA. The SBA guarantees loans to these companies and provides them with grants for small-business technical assistance. During 2009, NMVC companies financed twenty-four businesses with a total of $4.2 million.86

As described above, impact investments can be structured through various mechanisms to allow direct and indirect tax advantages, including deductions and credits for the initial contribution and reduced tax rates for subsequent investment earnings through private foundations. The following diagram illustrates the context for each of these mechanisms and the flow of capital to socially responsible investments and activities. Importantly, each of these mechanisms relies on the initial decisions by the sources of the investment – individuals, funds, and corporations – to begin the flow of monies through the system.

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### Figure 4: Estimated Interest Earnings on the Purchase of 501(c)(3) Tax-Exempt Bonds

<table>
<thead>
<tr>
<th></th>
<th>501(c)(3) Tax Exempt Bonds</th>
<th>Taxable Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>210,000</td>
<td>210,000</td>
</tr>
<tr>
<td>Tax Bracket (marginal tax rate)</td>
<td>33%</td>
<td>33%</td>
</tr>
<tr>
<td>Bond Purchase</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Bond Maturity</td>
<td>20 years</td>
<td>20 years</td>
</tr>
<tr>
<td>Bond Coupon (Interest)</td>
<td>4.5%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Interest</td>
<td>1,350</td>
<td>1,710</td>
</tr>
<tr>
<td>Tax of Interest</td>
<td>-</td>
<td>564</td>
</tr>
<tr>
<td>Net Interest After Taxes</td>
<td>1,350</td>
<td>1,146</td>
</tr>
<tr>
<td>Bond Yield</td>
<td>4.5%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

Source: Milken Institute, 2011
Figure 5: ‘Ecosystem’ of the Mechanisms and Flows of Social Investment in the US

Non-profit activities

Program-related Investments (PRI) - Commercially-reasonable rates of return

\[ 5\% \] Charitable activities

\[ 95\% \] Grants

\[ 5\% \] Qualifying Institutions, (e.g. religious, education, and scientific, etc.)

\[ 5\% \] Qualifying Projects, (ports, power plants, waste treatment, etc.)

\[ 95\% \] 501(c)(3) Organization

TAX DEDUCTIBLE CONTRIBUTION

INDIVIDUALS, FUNDS AND CORPORATIONS

TAX EXEMPT INVESTMENT

TAX CREDIT INVESTMENT

Money Management

Credit Enhancements

Development Loans and Investments

Private Equities

Environmental Projects

Low Income Housing

Historic Preservation

Community Development (e.g. financial institutions, venture funds, etc.)

Source: Milken Institute, 2011
Other Stakeholders in the Impact Investment Market

Besides the government, institutional and individual investors, intermediaries, and certain organisations also play key roles in the United States’ impact investment market.

Investors

Whereas the market for investments with social and/or environmental impact was once composed solely of purely socially motivated investors such as foundations, today investors of all types participate. Impact investors include:

• Institutional investors.
  
  Pension funds, insurance companies, and CRA divisions of banks all participate in impact investing. Some pension funds and insurance companies invest a portion of their funds locally, benefitting the population to which they have a fiduciary duty. Other investors view socially responsible investing as a whole as a financial strategy, positing that companies which take into account their stakeholders (eg, customers, suppliers, local communities, employees) are likely to build long-term shareholder value, unlike those focused only on the short term. Over 120 institutional investors from the United States have signed on to the United Nations’ Principles for Responsible Investment, which uphold the view that environmental, social, and corporate governance (ESG) issues can affect financial performance and should be considered part of an investor’s fiduciary duty. Signatories include the California Public Employees’ Retirement System (CalPERS), JP Morgan Asset Management, and Thomson Reuters.87

• Foundations.
  
  Foundations are increasingly investing their endowment and making below-market investments as an alternative to grants. These mechanisms allow them to increase the volume of their activities, thereby broadening their impact.

• Individual investors.
  
  High-net-worth individuals and retail investors are also increasingly participating in the impact investing market, finding that they can achieve financial returns while feeling good about their investments.

Figure 6: Impact Investing Map


Intermediaries
Certain entities facilitate impact investments. Examples of such intermediaries include:

• **Community-development financial institutions (CDFIs).**
  CDFIs serve low-income populations or economically distressed neighbourhoods that are often underserved by traditional financial institutions. These entities, which are certified by the US Treasury Department and eligible for federal funding, include community-development banks, credit unions, loan funds, and venture capital funds. Currently, there are 929 certified CDFIs in the United States.88 Capital under management in US community-development venture capital (CDVC) funds totalled $2 billion in 2009.89

• **Double- and triple-bottom-line funds.**
  These funds, which can involve investment in real estate, private equity, or venture capital, aim to achieve financial as well as social and/or environmental returns. The Canyon Johnson Urban Funds (CJUF), for instance, provide both debt and equity in support of urban revitalisation. Their investments are responsible for the creation of 16,000 jobs as well as the construction of 6,200 workforce housing units, 4.5 million square feet of community-serving retail and commercial space, and over $420 million worth of Leadership in Energy and Environmental Design (LEED) – certified buildings.90

Supporting organisations
A number of organisations also support the impact investing market and are critical in promoting its growth. Among them:

• **Social Investment Forum (SIF).** SIF is an association of professionals and organisations engaged in socially responsible investing. Formed in 1981, SIF holds conferences, researches the SRI industry, and increases the industry’s visibility, among other efforts.91

• **Opportunity Finance Network (OFN).** Founded in 1985, OFN is an organisation of community-development financial institutions and similar bodies investing in low-income areas of the United States. In fiscal 2008, its 170 member institutions invested $23.5 billion, which generated or maintained almost 230,000 jobs, as well as financed more than 51,000 businesses and microenterprises, over 630,000 housing units, and approximately 6,000 community facility projects.92

• **Investors’ Circle.** Founded in 1992, Investors’ Circle is an organisation of investors – including angel investors, venture capitalists, and family offices – who are also trying to promote a sustainable economy.93 Since inception, it has invested $145 million in over 220 companies and small funds addressing social and environmental issues.

• **Global Impact Investment Network (GIIN).** Created in 2009 by the Rockefeller Foundation, GIIN is a non-profit organisation dedicated to building the impact investing industry. It collects and commissions industry research and advocates for impact investing, among other efforts.

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88 Ibid.
Examples of Impact Investments in the United States

Impact investments are available across asset classes, from cash to private equity. They differ from philanthropy in that some return is expected – and that can be anything from a simple return of principal to market-beating returns. Examples of impact investments are presented below.

Figure 7: Examples of Impact Investments across Asset Classes

<table>
<thead>
<tr>
<th>FINANCIAL RISK &amp; RETURN</th>
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<tbody>
<tr>
<td>Low</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
</tr>
<tr>
<td>Deposits in community development financial institutions</td>
</tr>
</tbody>
</table>

Impact investments across asset classes

- **Cash: Deposits in Promerica Bank.** Instead of depositing cash in a national commercial bank, impact investors can place their money in a bank serving a low-income community or some other target population that is often overlooked by mainstream financial institutions. Promerica Bank, for instance, is a certified community-development financial institution operating in underserved areas of Los Angeles. Its mission is to become the leading financial services provider for Latino entrepreneurs. Cash deposits in Promerica support its operations, helping entrepreneurs grow their businesses and create jobs.

- **Fixed income: The Calvert Foundation’s Community Investment Notes.** Launched in 1995, the Calvert Foundation’s innovative financial product raises capital from investors and uses it to make loans to highly effective organisations, including those that develop or rehabilitate affordable homes, finance small businesses, provide essential community services, or create jobs. Capital from Community Investment Notes has been invested in communities in all fifty US states and in over one hundred countries. The notes are easily accessible to retail investors; individuals can purchase notes from an online platform, MicroPlace, for just $20. Investors can select their geographic, social, and financial targets, available at various terms and rates.

- **Public equity: US Community Investing Index.** This index positively screens for companies with strong track records in engaging economically underserved populations in the United States. In 2005, the Heron Foundation, looking for a public equity investment that met its mission, worked with Innovest Strategic Value Partners to develop an approach to this type of screening. Their work resulted in the US Community Investing Index, made up of over 350 large- and mid-cap companies from all sectors that measure favourably with regard to strategic alignment, workforce development and wealth creation, and community engagement and corporate philanthropy. Though this investment falls under the umbrella of socially responsible investing, it is less active than typical impact investments. Nevertheless, it represents one of the few ways investors can invest for impact through the public equity markets.

• **Private equity: Bay Area Equity Fund.** The Bay Area Equity Fund is a double-bottom-line venture capital fund investing in the San Francisco Bay Area. The fund recently made a $1 million equity investment in Revolution Foods, which provides healthy food, nutrition education, and operational support to California schools serving primarily low-income families. Since its inception, the organisation has supplied over 3.5 million meals to almost 40,000 students. Participating schools report that students have exhibited higher attention levels in class, posed fewer disciplinary problems, showed an increased interest in healthy food, and lost weight.\(^{95}\)

**Foundation impact investments**

Foundations approach impact investing slightly differently from the average institutional or individual investor. They can make impact investments either with the pool of capital allocated to grants (in which case, it is called a program-related investment) or with their endowment (a mission-related investment [MRI]). Although more US institutions are now making PRIs and MRIs, the subset of foundations doing so is still relatively small. Of the over 75,000 foundations in the United States, only ninety have joined More for Mission, a group advocating for impact investments.\(^{96}\) Nonetheless, foundations are channelling a significant amount of capital into this space, specifically in program-related investments.

• **Program-related investments.** As described above, PRIs are concessionary investments that foundations make to support charitable activities. Foundations invested $388 million in PRIs in 2007, the most recent year for which data are available.\(^{97}\) While a few foundations, such as the Ford Foundation, have been making PRIs since the legal form of the tool was introduced in 1969, many others, such as the Bill & Melinda Gates Foundation, have only just stepped into the picture.

  » **Below-market loan.** One example of a PRI is Meyer Memorial Trust’s $750,000 loan to Share, Inc., a non-profit based in Washington that serves low-income individuals and the homeless. The loan, which carries an interest rate of just 2.25 per cent, will help the organisation renovate a facility that will be used to provide services to its target population.\(^{98}\)

  » **Credit enhancement.** As part of its new PRI initiative, the Gates Foundation provided $30 million in credit support to help secure $300 million in tax-exempt bonds for charter school expansion in Houston. Although credit enhancement and debt guarantees are not an uncommon form of PRI, this was the first time a private foundation had backed charter school facility bonds on that scale. KIPP Houston, one beneficiary of the bond issuance, has had great success in sending its students to college – 90 per cent of its middle school students have gone on to higher education since the program’s founding in 1994. Due to its achievements, these schools have a waiting list that is almost double their capacity. The bond financing will allow them to serve more students.\(^{99}\) Numerous other examples...

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of credit enhancement utilise philanthropic funds invested at a concessionary rate to lower capital costs for public projects addressing social or environmental policy needs and cover credit risk through guarantees or the establishment of credit reserve funds.

- **Mission-related investments (MRIs).** Mission-related investing involves investing a foundation’s endowment with the intention of advancing its mission and earning a market-rate financial return. Using both investment and grant dollars in accordance with this mission increases the foundation’s overall impact. MRIs can also support specific activities that complement grants, increasing their likelihood of success.

  - **Private equity.** An example of a recent MRI is the W. K. Kellogg Foundation’s private equity investment of $500,000 in Acelero, a for-profit Head Start provider in New York City. Acelero will use the funds to bring its operations to scale, hiring quality teachers and paying them 60–80 per cent more than their colleagues in poorly performing programs. As a result of Kellogg’s and others’ investments, Acelero aims to ready 5,000 at-risk kids for kindergarten each year.

### Next Steps: The Growth of the Impact Investment Market

To grow the impact investing sector in the United States, a number of challenges remain. A survey by Hope Consulting illustrates several barriers to industry growth. The San Francisco-based consulting firm surveyed individuals with household incomes exceeding $80,000, the subset of the population that contributes three-quarters of total individual charitable donations. The study found that there is a $120 billion of market opportunity for impact investments. To realise this potential, however, obstacles must be overcome. Key challenges pertain to the immaturity of the market – its lack of a track record, a central source of investments, and investment advice. To meet these challenges, Hope Consulting recommended developing a clear explanation of what impact investing means, building awareness of investment opportunities, and educating financial advisors about impact investing.

As an industry, impact investing also needs a supportive infrastructure centred on shared definitions and methods of evaluating potential investments. The Global Impact Investment Network (GIIN), described briefly above, is working to develop this infrastructure. The organisation recently created the Impact Reporting and Investment Standards (IRIS), which provides a common framework for assess impact investments. Building on this framework, B-Lab has launched the Global Impact Investing Rating System (GIIRS), a rating agency that provides investors with information about the social and environmental impact of their investments.

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Conclusions

The US philanthropic market has evolved over the last two centuries, increasingly using innovative tools and approaches to leverage socially responsible investments towards a wide variety of social and community needs. As both wealth and social needs continue to grow, investors are finding new ways of mobilising their capital to meet these needs. With the help of effective federal programs to aid their returns and the economics of a broad range of project opportunities, social investors are leveraging their dollars (and efforts) to create direct and indirect impact and returns on their investments. Many important lessons can be derived from the process of financial innovation in the social capital marketplace. Moving beyond a simple binary public/private-sector categorisation of activity intended to qualify for tax benefits, investment incentives on the basis of the social or public-policy purpose of financing have opened new channels to investment opportunities that generate impacts for social change. The US experience is instructive in the mobilisation of financial tools to create mission-related investment products through which foundations and public charities can invest their portfolios in keeping with their social goals.
Chapter 4: Israel

The salient differences

The Israeli reader returning from our tour of developments in the UK and US will notice the difference between the approaches, means, and measures those countries employ to contend with social problems and those used in Israel. As described above, the British government has committed in the last decade to developing innovative ways of increasing external financial resources for the development of social enterprises, through a policy of focused intervention in disempowered communities. The US approach is different, partly because of its federal structure; the various social initiatives have developed mainly on the state level but sometimes also at the initiative of the federal government itself. Despite their differences in approach, both countries seek novel ways of tackling social problems, including new financing mechanisms, while developing a system of tax benefits and other economic incentives in order to attract new donors and other parties and to help social organisations.

In other words, the biggest difference between what is happening in the UK and US, and in Israel, has to do with new ways of financing social spheres, and the approach towards funding needs of social organisations. The first two countries are constantly searching for new resources, additional investors, specialised players, and novel ways of financing, including by granting economic, tax, and legal incentives to existing and new investors to increase their investment in social areas, and by establishing joint financing funds for the government and the business and philanthropic sectors, operated by specialised financing entities aiming to optimise those funds while using various financial instruments.

Another big difference is the attitude towards social-service providers and the desire to help them increase their revenues and organise in diverse and novel ways, partly so they can gain the financing and expertise they need to carry out their goals. This approach views social organisations as social-business enterprises whose economic development should be nurtured.

Thus, despite public recognition of the important role of Israeli social organisations in dealing with social issues, there has been no systematic response to their economic problems. Nor has Israel recognised that traditional donations and public budgets cannot meet the financing needs of these organisations, and innovative ways of increasing their sources of income and means of financing must be developed, so they can expand and develop the variety of social services they provide.103

103 For example, other countries include social organisations in the effort to find employment for the unemployed, weak populations, or those with special integration problems, and these organisations receive incentives to develop solutions, as do business sector organisations. For more information, see chapter 2.
We will now enumerate the salient characteristics of Israel’s approach to social problems, while detailing several differences between Israel and other countries we have reviewed.

Characteristic #1: Different social spheres – different financing mechanisms

A review of the Israeli government’s different ways of dealing with social problems indicates that it lacks a uniform approach to the means necessary to address these problems and the needs of social organisations. Different financing techniques are used in different areas, and the difference is apparent mainly in the incentives provided.

For example, the response to unemployment, which involves financing and incentives, as well as the assistance extended to small and medium businesses mainly reflect a clear recognition of the need to develop financial resources and provide economic incentives to employers. The government’s response to these social issues is intervention, by granting financing and credit (sometimes even by way of state funds or guarantees), incentives, and professional support. Furthermore, tax benefits are granted to employers, and government funds have been established to help small businesses obtain loans that the banking system refuses to grant.

This is completely different from the approach to other social problems, the economic benefit from the reduction of which is apparently less clear or less measurable in the short run, even though in the long run their solution would surely have a significant impact on society and the economy. Interestingly, social problems of this nature – such as poverty, violence, and youth-at-risk – are prevalent in the same populations that suffer from unemployment, and sometimes in the same localities. Yet the approach to confronting and financing these problems differs completely from the solutions offered for the problem of unemployment.

In these areas, the government mainly purchases social services from social and other organisations. The contracts are usually limited to one year, among other reasons because they come from the state budget, which until recently was annual. Such short-term contracting is in itself very detrimental to social organisations’ ability to plan and develop as well as to their ongoing fundraising efforts. The government also supports social organisations via the budgets of its various ministries. These support budgets are also annual, and their continuity is uncertain – another obstacle to organisational financing.

Furthermore, in funding social organisations, the government often relies on additional resources, namely the philanthropic monies the organisations raise. However, despite this heavy reliance on philanthropy to help address social problems, the only incentive to donate to social organisations in Israel is a 35 per cent tax credit up to a limited overhead, and only for contributions to non-profit social organisations that have received a permit to that effect from the tax authorities. An investment in or donation to a fund that helps finance social organisations does not entitle the investor/donor to a tax benefit.

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104 Ways of encouraging employment in disadvantaged areas include subsidies, tax benefits in national priority areas, and more.

105 Mainly by establishing government funds for small business loans, along with a separate support and consulting system as part of the Small Business Authority. Today combined methods are being studied.

106 By direct contracts or through JDC Israel (the Joint Distribution Committee), the main government arm for the development of social services.

107 See paragraph 46a of the Income Tax Order. Offering a higher benefit to philanthropic funds has recently been considered. See Law Memo – Companies Law (amendment 18) (the public interest fund and additional provisions concerning public interest companies), 2011.
The considerable difference in financing mechanisms may result from the different approaches of the parties dealing with the different issues, and from the fact that social problems are addressed by several government ministries: The Ministry of Industry, Trade, and Labour views itself as leading the response to the problems of employment and unemployment, whereas the Ministry of Welfare is responsible for dealing with the social problems of disempowered populations together with the Ministry of Health which works with similar populations in relevant areas. Confronting unemployment is recognised as a ‘growth engine’, whereas reducing other social problems is not necessarily considered as such.

The difference between the two ministries is obvious: The Ministry of ITL grants economic incentives that are also encouraged by industry and are therefore easy to implement. In contrast, the Ministry of Welfare buys services, some of which it provided in the past, and therefore does not necessarily view service providers as social enterprises which should be helped to develop and fulfill their goals. That is why, though both ministries often assist the same populations in the same locations, the Ministry of Welfare has not prioritised issues such as financing or incentives.

Another difference is the absence of an integrative regional effort on the part of the entire government mechanism treating the same population. In the UK, for example, government involvement typically comes from a regional-community perspective seeking to pursue a variety of means and measures in order to develop an area along with all its residents and organisations. In Israel, however, despite the advantage of being a small country, no such integrative regional view guides the various bodies responsible for problem areas, and no integrated solutions have been developed for the social organisations operating in these areas or for their populations. Furthermore, besides the government ministries there is another player in the field: the local authorities, subordinate to the Ministry of Interior, which are also responsible for dealing with the social problems of the populations in their areas. A few years ago, a government ministry was established to develop the Negev and Galilee districts, but this move does not seem to have led to an integrated perspective on how the various ministries and authorities can work together.

Characteristic #2: Decentralisation of resources and multiplicity of allocation and distribution mechanisms

Another salient characteristic with implications for the financing of responses to social problems in Israel is the decentralisation of resources. The various financing bodies – government ministries, local authorities, public organisations, and philanthropies – each operate in their own way, channelling large amounts of money into addressing social problems in diverse ways, such as by purchasing social services subsidising social activities, offering economic incentives, or making donations.

Resource decentralisation is one reason for the multiplicity of mechanisms and criteria used in distributing government and public funds to social causes. The Israeli government allocates substantial funds as support budgets distributed according to principles enshrined in law and requiring the establishment of criteria and detailed distribution mechanisms. The result is a complicated distribution process and a profusion of distribution mechanisms used by the various government ministries, the local authorities, and all other public bodies.

108 As well as the Health Ministry, which buys health services for various needy populations.
109 Such as the National Lottery or the National Estate Fund, which are not part of the state budget.
110 The total support budgets distributed by the government in 2010 exceeded NIS 24 billion. For a breakdown of support data, see www.tmichot.gov.il/.
111 Paragraph 3a(d) of the Budget Foundations Law, 5745/1985, sets forth the principle of equality: ‘the amount established in a budget line for a type of public institution will be divided among public institutions of the same type by equal criteria’.
This decentralisation of budgetary resources and multiplicity of distribution mechanisms is very costly and offers no opportunity to pool at least some of the money from government, public, and philanthropic sources and use it through new financing mechanisms. Pooling these funds could enhance their use and achieve financing advantages such as leverage or combination with funds from the business sector or the institutional market.

Another disadvantage is the difficulty of assessing the effectiveness of any given intervention. As a rule, it is hard to test the effectiveness of solutions to social problems, and the difficulty becomes even greater when resources are decentralized and the various bodies each allocate money separately.

The current system also has substantial implications for the way social organisations operate. These organisations must often approach several sources to fund the same activity or similar activities in the same area: They appeal to different government ministries and local authorities to purchase their services or help them with support budgets, and to complete their funding they approach donors as well. Thus, they must devote time and resources to fundraising instead of being assisted, for example, by financial institutions specialising in social issues. Such entities (which exist abroad) could help professionally with the organisation’s economic administration as well as tailoring a financing package to its needs, combining the financial resources of different parties with different risk preferences. Another obvious drawback of the present arrangement: Since it is impossible to pool the various sums in advance, it is doubtful whether the large amounts of money invested by the various parties are producing as much benefit as they could by other means of financing.

In other countries, different means have been developed to enhance the use of the money invested in achieving social goals, in the belief that novel ways of financing can increase financial resources and meet the capital, credit, and other financial needs of social organisations. Consolidation of government, philanthropic, and business resources, including through special funds or similar institutions, would allow their judicious use at the discretion of investors, through financial instruments developed to match financial means to the needs of social organisations at various stages of their operation. Two prominent examples of such consolidation are the establishment of a bank for non-profits and the creation of social investment and financing funds.

The UK’s Charity Bank was established as a central player in the credit market, assisting social organisations in the form of various loans for development or current needs; the bank’s capital resources are government, public, and philanthropic funds. The use of those resources to establish a ‘bank’ attests to new thinking, according to which a bank can meet the financing needs of social organisations better than the government or even the funds themselves. The establishment of social investment and financing funds is also the result of innovative economic thinking, according to which effective resource use requires consolidation and specialisation, and resources can be increased by bringing in investors from the business sector while using philanthropy funds as a sort of safety net for their investments.

Social services cost money, and the government’s desire to allocate the national budget fairly and optimally is understandable. However, the decentralisation of resources and profusion of distribution mechanisms squander the tremendous economic advantage that could have been achieved by consolidating even a fraction of resources while enhancing their use and allocation according to the needs of social organisations, by means of professional bodies that specialise in social financing.

A responsible approach would require a comprehensive view of the government’s social service budget and a search for new ways of increasing and optimising financial resources.
Characteristic #3: A different approach to financing and credit

In the UK and US, credit access is a central plank of social policy. These and other countries focus on certain areas or distinct communities and try to empower and develop them economically by means of various incentives, with the help of local and professional financial resources, especially if the regular banking system operating in that area fails to provide an adequate solution.

Credit and financing in Israel is quite different. The main credit provider is the banking system; non-banking credit is usually extended to public companies, but for various reasons there is no systematic\textsuperscript{112} solution outside the banking system for social organisations or individuals. No non-banking institutions provide credit for regional development, unlike in the US, the UK, and other countries, which have community development financial institutions. The focus on the development of the Negev and Galilee in Israel could change the financing approach to those areas.

Though in Israel there is less competition between banks than there is abroad, countries like the US and UK have developed a financing approach to the needs of disempowered populations and the social organisations serving them. Establishing community financial institutions and granting tax and other benefits to their investors represent a philosophy of appreciating the economic expedience of providing a professional response to the credit demands of the members of those communities as well as the social organisations working for them.

The difference between Israel and other countries is also evident in the absence of ‘social-financial intermediaries’ operating in social spheres and among social organisations. No social financing funds in Israel today aim to provide professional support, to design and tailor financing resources to the needs of these organisations. Furthermore, though several funds provide loans to small businesses, almost all operate through the banking system and follow procedures different from those practised in the world of micro-financing. It is very doubtful that this arrangement meets the needs of the non-profit organisation, the main model of social organisations in Israel today.\textsuperscript{113}

Characteristic #4: A different public policy regarding social organisations

Regarding unemployment, the Israeli government views the business sector as its principal ally and grants economic incentives to members of this sector who provide jobs to various populations, including the unemployed and the disabled. These incentives, which change periodically, include grants for companies that hire workers in places where there is unemployment, subsidies for employers who hire unemployed workers, and sometimes even tax benefits. This approach might result from the assumption that businesses operate to produce profits for their shareholders and therefore should be given economic incentives to undertake an activity that might be less ‘economical’ for them, to compensate them for its lack of profitability. In other words, the government rewards the business sector for helping it deal with social problems.

The government’s attitude towards social organisations is different. The government does not appear to view them as ‘businesses’ that need to operate economically in order to achieve their public goals, possibly because most if not all such organisations are non-profits. Perhaps that is why the price the government is willing to pay for the services they provide – often instead of the government – does

\textsuperscript{112} The main way of providing for the credit needs of individuals rejected by the banking system, and of small businesses whose demand is not met by the few operating funds, is the ‘grey market’.

\textsuperscript{113} Several funds assist small businesses in Israel today. All are government initiatives financed by government funds or guarantees and operated through the banking system. KIEFD on the other hand, is funded by donations from the US, where contributions to funds granting this type of loan are recognised for tax purposes, as opposed to the situation in Israel. For more on this question, see www.moit.gov.il/NR/exeres/847DE045-9797-46E9-8489-784C41B0672D.htm and the summary of a study on the subject: www.kmifellows.org/research/HEB_S/40-HB-S.pdf.
Social Capital Market for Israel

Social organisations must take into consideration that even a social organisation, although it does not distribute profits, requires economic stability, so it can develop and not incur losses or underpay its workers.

A ‘non-profit’ works for a public-social goal rather than to make money for its shareholders. But that does not mean such an organisation should operate with a deficit and never have ‘profits’, meaning a surplus of income over expenses, which it can reinvest in development and growth. There is no law against a public interest organisation’s having surpluses, as long as they are not distributed to shareholders or members of the organisation but are used solely to further its public goal. Furthermore, an organisation must sometimes incur surpluses so that it cannot only survive but also develop and grow. A social organisation is a ‘business’ that must operate effectively both economically and to achieve its public goal; if expenses exceed income, it might go bankrupt. It is often desirable for a social organisation to have income from a secondary economic activity in order to increase its financial resources and grow, develop, and provide more or more varied social services.

Like a business, a social organisation develops in stages: start-up, operation, viability, and growth; it needs adequate physical and technological infrastructures, which require financial resources and mechanisms adjusted to its different stages of development. Without these resources and mechanisms, it cannot grow, thrive, or address growing social needs. The failure to attend to the organisational, financial, and operational needs of social organisations hurts not only the organisations themselves but the consumers of their services and society as a whole.

A social organisation faces greater economic challenges than a business, because its main income sources are usually donations and public allocations. Such resources are limited and are not given in exchange for services, so they do not necessarily grow with the demand for services or the needs of the target populations. Reliance on public allocations through the purchase of services from social organisations is not easy, especially since contracts are usually short-term, so organisations cannot count on the buyer in the long term, which would allow them to receive interim financing, for example.

The economic difficulties facing non-profits should have led to the development of diverse means and tools of investment and interim financing or credit to help them, as has occurred abroad, but the situation in Israel is just the opposite.

Another problem is the attitude of the various parties that oversee social organisations. These parties, such as the accountant-general and the Corporate Authority, have developed unique inspection methods to guarantee that most of the money allocated to these organisations is channelled into social goals, thereby allaying concerns of abuse of public funds. These concerns derive from the structure of non-profits. Investors are external to the organisation – being neither shareholders, directors, nor beneficiaries – so it is necessary to ensure that donor and investor money reaches its target: the recipients of social services.

But these tests can interfere with social organisations’ important work and are not always adjusted to their organisational, economic, and financial needs. For example, the focus on administrative expenses, whose purpose is to prevent excessive salaries, often hinders the development of the organisational and technological infrastructures necessary for effective operation. Organisations fear that spending money on these needs will invite criticism by the Corporate Authority, which could even revoke its seal.

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114 See, for example, the definition of a public interest company in the Companies Law.

115 Several bodies oversee social organisations: the Corporate Authority; the accountant-general, who oversees bodies receiving support from the state budget; and the government ministry in charge of the organisation’s area of activity, which sometimes also purchases its services.
of approval. Furthermore, to prevent asset concealment, the law limits non-profits’ use of assets. Therefore, a non-profit or public utility faces many difficulties when seeking loans from banking institutions, which ask for securities to guarantee loan repayment by way of asset mortgaging.

A social organisation’s financing problems manifest themselves throughout its existence, from founding to development and growth. Among many other constraints, the organisation has difficulty obtaining financing to bridge gaps between times of revenue receipt, trouble securing loans for current or development needs, and difficulty mortgaging assets, and it cannot receive credit without liquid securities. All these problems, plus limited resources, make the work of social organisations in Israel extremely difficult.

Thus, despite recognition of the important role of social organisations in Israeli society, we have not found a consistent response to their economic problems and the need to develop financial resources and financing mechanisms adequate to their stages of development, thereby guaranteeing their activity during times of growth and crisis.

Characteristic #5: A range of organisational models

Social organisations in Israel also differ markedly from those in other countries we have reviewed in their organisational structure and in the attitude of supervisory bodies to their development of secondary sources of income and social enterprises. A social organisation working to rehabilitate excluded populations might build a plant to employ homeless people, or it might manufacture products or provides services that generate revenues which serve to finance its activity on behalf of disempowered communities, and these profits might be distributed to its owners or reinvested in the business. This is not a common model in Israel, and such organisations are unlikely to receive the government incentives that businesses do, or tax benefits for their donors or investors. This situation is the complete opposite of that in the UK and US.

Since the beginning of this century, social enterprises have become widespread. Many people wish to work for social causes through economic and business means, which often produce significant outcomes for target populations. For example, establishing businesses to employ newly released prison inmates might contribute more to their rehabilitation than finding employers willing to hire them. These enterprises include many different organisational models, from organisations that do not distribute profits to organisations working both for profit and for social impact. This new world of social organisations is in its inception in Israel and confronts many obstacles erected by the very regulators in charge of non-profits, especially the tax authorities. The idea of an organisation’s operating on an economic model and running a business whose profits serve a social goal may be unfamiliar, but that is no reason to reject it; it is the regulation that ought to be adjusted to the model. Interestingly, the business community has begun to show interest in this approach and a willingness to combine financial and social returns.

The assumption in the countries we have reviewed is... that, to meet social challenges, social organisations need diverse organisational models, special tax laws, and diverse incentives for donors and investors.

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116 During the 2009 economic crisis, the government established a fund to help organisations facing difficulties, but it was a local solution and not part of a coherent policy on this issue.

117 This difference is particularly evident in the approaches of the British and Israeli governments. See chapter 2.

118 See the extensive discussion in chapter 3 as well as, for example, www.socialenterprise.org.uk and www.enterprisingnonprofits.ca.

119 The REDF organisation works this way. See www.redf.org.

120 See Benziman, ‘Not by Philanthropy Alone’.
The point of departure in the countries we have reviewed is completely different: These countries recognise that, to meet social challenges, social organisations need diverse organisational models, special tax laws, and diverse incentives for donors and investors.

Furthermore, the principal starting point in these countries is that organisations must be allowed to develop diverse income sources so they can further their social goals. Those resources can serve the same goal, such as the opening of a restaurant employing youth-at-risk or people with disabilities; they may also be used for separate businesses, such as stores whose profits serve the homeless, or even solar energy facilities on the rooftops of the community’s public buildings, the income from which is channelled into community needs.  

In conclusion, financing social areas is a challenge. The idea that donations and allocations alone can meet the financing needs of social organisations must be replaced. New ways to invest must be developed, and capital must be attracted from the business sector with the help of entities that specialise in both finance and social causes: the ‘social-financial intermediaries’. These expert players, in the form of different kinds of investment funds or other entities, can develop the social capital market in Israel. This will streamline both the supply side – by pooling funds from different sources and developing novel means of financing – and the demand side, by the social-financial bodies’ enhancing the economic conduct of social organisations and making them investable. The development of the social capital market in Israel may result in a quantum leap in contending with social challenges.

Despite initial signs of activity that began with the call for proposals emanating from the roundtables at the Prime Minister’s Office in September 2010, there is still no clear recognition that the development of diverse financial resources is the best way to help social organisations grapple with social problems.

We believe it is necessary to develop social investments and improve investment financing, and to do so by learning what is happening in this area in other countries. This process should transform the social field. Philanthropy should be seen as a financing party, not just a source of donations. Various financing funds should operate in social areas – by capital investment or various ways of providing credit – and include public, philanthropic, business, and institutional investors while granting appropriate incentives.

Therefore, there is a clear and immediate need to change the existing financial models in the social realm in Israel and add new ones, since novel mechanisms are the only way to harness new capital resources and invest them in social areas. New mechanisms and models will provide an adequate economic solution for social organisations and help them function, develop, and expand their service to various populations, as is necessary to contend with Israel’s major social challenges.

**Recommendations**

The starting point for the following recommendations is that the Israeli government must play a central and exclusive role in changing the existing approach to financing the response to the country’s social problems. Only a new governmental approach can develop social investments in Israel, consolidating governmental, public, and philanthropic resources along with those of the business and financial sectors and channelling them into the development of a ‘social capital market’.

The first step is to recognise that, like the business sector, social issues and the organisations working on them require more financial resources than presently exist. Government budgets and philanthropic...
funds will always be limited, so even if they grow considerably, it will be necessary to develop ways of enhancing allocations and using existing financial resources, as other countries have done. Learning from them, we believe that the consolidation of governmental and philanthropic resources can create an adequate basis for bringing in capital from the business, institutional, and financial sectors, optimising the use of existing resources in combination with new ones, and satisfying the risk and profit appetites of various investors. Even profit-oriented investors have come to understand the social and economic importance of investing in social areas. The development of financial tools in conjunction with the right incentives can increase the total resources invested in dealing with social problems and meet the financing needs of the social organisations working on them.

These measures have several goals. The main one is to ‘enlarge the pie’, to increase the total resources devoted to social issues and the needs of social organisations. However, we must also ensure that existing and new money is allocated efficiently, providing the most effective response to social problems. To that end, ways to improve the functioning of social organisations must be developed. The next stage will be to develop tools to measure their social impact, so they can present themselves as investable.

To realise these objectives, a social capital market must be developed with a variety of specialised players using innovative means and financial instruments, such as those used in the capital market, to enhance the use of the different funds and tailor them to the needs of social organisations while providing professional support for their development.

Recommendation #1: Establish social investment funds

Social investment funds have distinguished themselves abroad as vital players in the development of social investments, because they specialise both in pooling funds on the supply side and in adapting them to the capital or credit needs of social organisations, including by way of novel financing instruments that satisfy investors’ various preferences. These funds also facilitate more effective use of philanthropic money, because they can attract additional investors and leverage the use of their investments, thereby producing a greater social impact than would have been achieved by donating to an organisation directly. Another significant aspect of these funds is their professional ability to enhance and develop the functioning of social organisations as part of the investment process.

There are different kinds of investment and financing funds, and incentives to invest in them should be tailored to each investor. The integration of philanthropy money into these funds requires some kind of tax benefit to go with the philanthropic investment, or else donors will prefer to donate to an organisation directly instead of enhancing the use of their money and investing it in an investment fund, where it might serve as a safety net for the business investor. In the UK, a distinction was made for regulatory and tax purposes between community development finance associations (CDFA) and investment funds, and that approach should be considered as well.

The development of social investments requires a vanguard. Therefore, we suggest that the Government consider establishing a fund for social investments, which would create financial means of contending with social problems while developing the investment techniques and financial instruments that exist in the capital market and adjusting them to the social realm.

Such a fund could be financed by government money or in collaboration with other investors from the business, institutional, and philanthropic sectors. At a certain point, management could be transferred to new investors.122

A government fund operating according to such a model could be an incentive to establishing private social investment funds, but first the numerous barriers that might inhibit the activity of such funds

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122 That is how the government encouraged high-tech investments when it established a company called Yozma, which was later privatised.
must be removed. These are mainly tax barriers, namely the lack of recognition that philanthropic investments in a fund of this sort resemble donations and are therefore entitled to a tax benefit.

A somewhat different approach is to invest government or public money (such as the proceeds from the national lottery) in an investment fund established by non-governmental investors, like the British government and Big Lottery investment in Bridges funds.

Whether social investment funds are governmental or private, it is also important to develop sources of investment in them: Israel’s philanthropic resources are not as substantial as those in other countries, so appropriate incentives must encourage business sector players to invest in such funds alongside philanthropic bodies.

**Recommendation #2: Invest public funds in significant social projects that produce economic returns**

The volume of non-governmental financial resources available for social investment in Israel is not large. Furthermore, as opposed to other countries, Israel lacks philanthropic foundations with substantial financial resources, and when investing in social areas, the existing foundations usually do not invest their own capital, only their profits.123

Therefore, new financial resources must be developed. One of the most suitable resources for social investment yielding long-term returns is the public money invested in pension and provident funds. The managers of these funds are interested in solid, yield-bearing investment channels and already invest in infrastructural projects such as the Trans-Israel Highway.

The use of these resources also has socio-economic justification: The investment of public money in social areas serves the saving public as well, because its purpose is to strengthen the social fabric and address the problems that undermine social cohesion; the saving public will also benefit from social investments, earning returns both as investors and as citizens. Concern for future generations is the province not only of the government but also of those saving for retirement, so their investment in social areas with reasonable, solid returns is both an economic and a social one.

One way to invest that money is in investment funds, where both government and philanthropic funds will be invested, as is the case abroad. Since the money in question is the retirement savings of policy holders, it must be guaranteed to yield solid interest, as is customary in the capital market; certain investment channels guarantee that.124

Another option is to provide a sort of ‘safety net’ for investors, similar to recent government efforts to encourage institutions to invest in high tech: Institutional investors were promised that if the return on their investment fell below a specified rate, the government would make up the difference (within limits).

This model could enable institutions to invest a small part of public funds not only in high tech but also in social areas, producing both economic and social returns, through a variety of models that could be developed, including a government safety net. The government too would profit from investing in

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123 A few foundations, such as the Rashi Foundation, operate differently.

124 One example is the leverage funds the Israeli government established in 2009 to deal with the global credit crisis. These investment funds, which specialise in granting credit to refinance debt and manage debt arrangements, were established in partnership with the private sector, but the state took most of the risk for the funds’ losses. See www.mof.gov.il/Pages/Manof.aspx.
these areas, which would increase the sources of social funding. But in order for these investments to produce a reasonable, solid profit, the bodies in charge of budgeting the social services must budget them at a fair price that includes the financing needs required to guarantee the viability, development, and growth of the organisations providing the services. The underfunding of social services will not solve the problem of the need to fundraise from new sources and will undermine social organisations’ survival not only today but in the future.

**Recommendation #3: Create a variety of investment and taxation incentives to encourage investments in social fields**

Whereas everyone agrees on the paramount importance of increasing the resources directed towards investment in social areas, there is still no recognition of the need for diverse economic and tax incentives to invest in a variety of new mechanisms, whether directly or through specialised players such as social investment funds.

As noted, social investment funds could increase capital resources and enhance their use. But there is a major barrier to investing philanthropic money in such funds, because the investment is not recognised for tax purposes in Israel, unlike in other countries.

Therefore, first of all, the tax laws must be changed so that gifts to social investment funds are recognised as donations, with all that implies. Donors to the different social funds – including investment funds that produce profits for their investors – must receive benefits equal or similar to what they would receive for direct donations to non-profits or public interest companies.

Meanwhile, novel incentives must be developed – as in other countries – to bring money from the business sector into investment funds. These incentives might include a certain credit or deduction of the capital investment sum in special investment tracks. Such incentives already encourage investment in other areas, such as capital investments.

Another way of encouraging investments is by allowing social investment funds to raise capital from different investors and by recognising the interest on the debt for tax purposes, just as the interest on Israel Bonds, which raises funds for Israel, is tax-exempt for bond purchasers in the US.

Fundraising and resource development for social issues requires creative, innovative thinking. The development of economic and tax incentives, even if only for a limited time and at least in the early years, is critical in order to convince business and other investors that investment in social issues pays. We must learn from other countries and from what Israel itself has done in other areas requiring innovation, and implement the diverse methods that have been developed while adapting them to the need to increase resources for social activity in Israel.

**Recommendation #4: Adopt a new approach that encourages social enterprises**

Social organisations have limited resources, while the social challenges they confront are numerous and complex. That is why it is so important to permit these organisations to develop sources of income and find innovative and viable solutions to social problems, such as prisoner rehabilitation, on-the-job training for remote populations, and more. To that end, the attitude towards social enterprises – which have recently appeared on the Israeli scene – must change. Such enterprises thrive abroad and provide social-economic solutions in many areas.
A change of approach means that these enterprises must be allowed to develop new resources and find ways to create income. For example, they must be allowed to recruit investors interested in an economic return on their investment – whether through capital investment, which means profit distribution to investors at a certain level, or through yield-bearing contracts such as long-term loans, royalty agreements, and so on.

For that purpose, a new kind of incorporation must be added to the Companies Law: a social corporation that is allowed to distribute a defined share of its profits to its shareholders, like the community interest corporations that exist in the UK. Other kinds of corporations that entitle their investors to tax benefits exist in the US, and the system there can also be implemented in Israel.

Second, existing social enterprises must be allowed to develop commercial activities, whether related directly to the organisation’s social goals or in the form of independent commercial activity whose revenue serves these objectives. We acknowledge the difference between these two kinds of commercial activity, and there may be different incentives and taxation for each one; however, the difference between them does not lessen the importance of each one for the development of income sources for social enterprises.

As noted, business activity of the first kind, which serves the goals of the social organisation directly, is a source of income for the organisation but just as importantly an opportunity to integrate its target population into the community and the workforce. This type of activity can be vital to the success of the initiative and is sometimes the only way to integrate that population. For example, an organisation that serves excluded populations such as people with disabilities or youth-at-risk, and develops sources of employment adjusted to their needs, is sometimes the only party that can employ these people, because other employers are averse to the challenges of their employment.

Developing sources of income that create jobs for excluded populations is a goal that must be encouraged and pursued, not blocked just because it does not match the traditional modes of operation of non-profits. This new approach is needed urgently given the tax authorities’ nebulous attitude towards organisations that operate as non-profits or public interest companies and are involved in business-like activities that produce income and sometimes even profits. The same is true for providing incentives to such organisations for the employment of excluded populations. Needless to say, in the UK and US the government encourages commercial activity by social organisations, especially those employing excluded populations in the diverse and creative ways described above.

The main barrier to the development of social enterprises in Israel is the tax system, which does not view commercial activity by a non-profit as a legitimate way to create income and therefore, as a rule, imposes income or profit limits, even if those revenues are not distributed. Another inopportune element of the tax system is the strict dividend policy applied to non-profit organisations with profitable subsidiaries: The profits distributed to these non-profits are taxed at 25 per cent, whereas dividends between corporations are tax-exempt. The rationale: If such dividends were to be distributed to a shareholder at the end of the chain, he would be taxed as an individual; whereas a non-profit organisation cannot distribute dividends to shareholders, and therefore the tax is imposed on the non-profit itself. The taxation policy for non-profits should be reconsidered and adjusted to the new era in which we are living, which is undoubtedly the era of social investments and social enterprises.
Afterword

The vision presented in the report before you is not as distant as it may seem. It can be achieved in Israel. The accumulated tools, knowledge and experience already exist in countries around the world as well as here in Israel. However, realizing this idea demands innovative economic thinking by the government and by policy makers that recognize the importance of achieving both economic and social revenue for the benefit of humankind. An innovative social economic policy must operate with the creativity required to marshal new forces and economic resources, and by doing so, transform yesterday’s problems into the driving forces behind tomorrow’s growth. In the spirit of the times, the moment has come to embark on a new path.

In the course of its work the group met with individuals in Israel and abroad. Among them were:

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