Government and the impact economy
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A quiet revolution is changing the way our society seeks to create social good. A new generation of entrepreneurs, investors and nonprofit leaders is working to develop profitable and socially conscious business and investment models. This is the impact economy, a small but growing sector that seeks to put the achievement of social good at the center of business.

The impact economy already includes enterprises that employ as many as 10 million and produce an estimated $500 billion in annual revenues in the U.S. alone. Current estimates of the growth potential for impact investing — pursuing returns blending social, environmental and financial benefits — range between $400 billion and $1 trillion by 2020.

The most recent innovation in the impact economy is the social impact bond, in which investors provide capital for social interventions and government agencies repay them if and when the services deliver results. Since the first social impact bond launched in 2010, targeting a reduction in recidivism at England’s Peterborough Prison, 16 similar deals have been initiated in the United Kingdom and nine in the U.S. Social impact bonds are a subset of a fast-growing number of financing models, sometimes called Pay for Success (PFS), which link payments to results. Many such deals are in progress around the U.S.

These activities as well as other innovative financing mechanisms have contributed to an ecosystem in which a range of support organizations are eager to participate in the impact economy. Some have a long history in the pursuit of social progress, such as foundations and community development financial institutions, while others, such as mainstream financial institutions have traditionally been less heavily involved in achieving social progress. With the rise of the impact economy, all have an opportunity to challenge conventional thinking and reinvent their models.

Government can play a key role in supporting the impact economy to achieve its full potential. Impact investing, social enterprises, and social impact bonds won’t replace public services, but can supplement and enhance them and ultimately improve their performance. By harnessing private capital for social goals, the impact economy can help service providers reach more people in need, efficiently and cost-effectively. In addition, by building sustainable and socially motivated businesses, the impact economy can create jobs and new incentives geared toward more sustainable practices and long-term social good.

A number of ongoing initiatives seek to accelerate the impact economy through policy innovation. Before the 2013 G8 meeting in London, the British government hosted a forum on impact investing
that led to the creation of a Social Impact Investment task force charged with examining policies could help accelerate its growth. vi The task force is expected to publish its findings in September 2014. A U.S. advisory board, in close collaboration with a parallel initiative called AI3, or "Accelerating Impact Investing," is identifying domestic opportunities for change. vii

The federal government can support and cultivate the impact investing market through several of its traditional roles:

- as a convener or "market facilitator," viii by providing resources and infrastructure and building relationships among those engaged in building the impact economy;
- as a buyer of goods and services, by focusing more public resources on achieving social outcomes; and
- as a regulator, by crafting regulations, policies and incentives that drive more investment capital into the impact economy.

This report provides concrete options for government action in each of these three areas. Our ideas come from conversations with more than 50 practitioners across the government, nonprofit, philanthropic, and investing sectors. viii
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Government can participate in and support the impact economy as a convener, buyer, and regulator.

**Government as a convener and market facilitator**

One of the federal government’s more powerful tools is its unparalleled ability to convene, foster dialogue, and encourage collaboration. Such meetings also help signal the government’s commitment to specific policies and issues. For example, the Obama administration has held two meetings on PFS models, one in 2011 and another in 2013, to educate stakeholders about these tools.¹ Using its convening power to bridge gaps between sectors and encourage knowledge sharing can contribute greatly to the growing impact economy.

**Build a repository of leading practices**

Today, state and local governments seeking to implement innovative financing mechanisms or PFS models often work in isolation. Right now, each deal is custom-made and time-intensive.

By convening state and local officials and other groups working on PFS and social impact bond agreements, the federal government could help create a comprehensive set of recommended practices. Doing so would make it easier for more governments to adopt these models while reducing ambiguity for investors, making various deals more readily comparable.

Such a repository of data could include information on how to value social outcomes; how to choose the best evaluation methodologies for various situations; how to structure PFS contracts; what to look for when choosing an intermediary; and what information to take into account when negotiating investor returns, as well as sample legislation.

A useful model for a U.S. effort is the UK Cabinet Office’s Centre for Social Impact Bonds, which has published sample social impact bond contracts and a database of cost information for more than 600 social issues.²

**Develop platforms to facilitate investment**

Matching investors with investments can be a laborious and unpredictable task, but advancing technology and the growth of the impact investment market may allow for better methods. Impact investment requires the consideration of a wide range of information, including evaluation methodologies, service provider performance and standards of evidence for social interventions.
The federal government could convene investors, intermediaries, social enterprises, and other players to design a platform to connect investors with investable impact opportunities. While the government itself would not necessarily be responsible for funding, building, or hosting the platform, it can and should contribute to the conversation leading to it.

**Standardize and track metrics**

Current methods for measuring social good are driven by individual investors, each using its own ways to measure the impact of its investments. The lack of common metrics makes it difficult for new entrants to the market to compare different business models and investment opportunities.

Many of the metrics used, moreover, are inadequate, tracking inputs (e.g., contact hours with a health coach) or outputs (e.g., hours of physical activity) rather than the results achieved (e.g., reduction in obesity levels). This makes it difficult to gauge whether an investment will actually make a difference and if so, how much.

As with platform development, the government could lead an effort to accelerate the adoption of uniform standards of measurement for impact investments, social enterprises, and other impact economy tools. Standardized metrics would help improve transparency in the sector by making it easier to compare transactions, business models, and the impact of given interventions, allowing investors to make more informed decisions.

**Create dedicated impact funds**

Investment opportunities in values-based enterprises are not readily available to retail investors, and unproven for institutional ones. The United Kingdom, however, has created a bank entirely dedicated to social investment which now effectively helps “crowd in” new investors. A 2008 law permitting unclaimed assets and dormant bank accounts to be put to use for social purposes eventually was used to finance Big Society Capital, which opened its doors in 2012.

While complex state regulatory barriers in the U.S. are likely to preclude a similar effort, the federal government could consider using other sources of alternative capital and aligning existing federal and State Funds, to create a privately run Enterprise Impact Fund.

**Government as a buyer**

The federal government is a major purchaser of goods and services, particularly in the social sector. In 2010, a survey found that 33,000 social service organizations held 200,000 contracts and grants with federal agencies — and federal money was the largest funding source for about 60 percent of those groups. Government procurement, therefore, has incredible potential to promote the impact economy.

**Fund Pay for Success and other performance-based programs**

Governments tend to buy inputs and outputs rather than real-world outcomes, and restrictive legal definitions often preclude better and cheaper ways of achieving the desired end. They tend to decouple spending from the impact sought, thereby diminishing accountability for effectiveness.

PFS and social impact bonds, however, are designed *precisely* to tie spending to the outcomes achieved. The federal government can use its spending power to spur the widespread adoption of these and similar mechanisms.
First, Congress could grant federal agencies latitude to use PFS approaches in existing programs. The Obama administration has already cited two statutes providing this flexibility:

- the Second Chance Act, which authorized the U.S. Department of Justice to make provide planning and implementation grants and award research funding to the Urban Institute; and
- the Workforce Innovation Fund at the Department of Labor, which in 2013 awarded almost $24 million to New York state and Massachusetts to support social impact bond agreements.\textsuperscript{xiii}

The administration also permitted cities and states receiving the second round of Hurricane Sandy relief funds to use PFS approaches in their action plans.\textsuperscript{xiv} The recent omnibus appropriations bill, moreover, permits the Social Innovation Fund at the Corporation for National and Community Service to use up to $14 million to support PFS approaches.\textsuperscript{xv}

But many more federal agencies and programs could support cities and states seeking to use PFS tools to boost government performance, scale preventive social services, measurably improve outcomes, and — where feasible — save money on remedial services. To facilitate this, Congress could extend PFS authority to the departments of Education, Labor, Justice, Health and Human Services, Commerce, Housing and Urban Development, and Veterans Affairs.

Congress also could endorse the administration’s proposal to create a $300 million PFS Incentive Fund at the Treasury Department.\textsuperscript{xvi} This fund could help address several challenges currently facing the social impact market.

First, it would create a central federal entity to collate knowledge, set standards for transactions and provide guidance to other agencies. Secondly, the fund could provide “top-up payments” for states and municipalities entering into social impact transactions when some financial benefit would accrue to the federal government. And finally, the Incentive Fund could accelerate investment in social impact bond and PFS transactions by offering enhanced credit for qualified investments, a function that could be designed with a sunset provision to pull back after the market has been established more firmly.

**Direct investment and grant capital toward social enterprises**

Impact organizations and social enterprises often need considerable early-stage, risk-tolerant capital to get off the ground. The federal government can direct existing investment and grant capital pools to make its resources available to impact organizations with viable long-term business plans. Early support from the government could help them attract additional private investment at reasonable rates.

Success rates for small- and medium-sized businesses are often low, and an in-depth feasibility study would be required to establish the right terms and conditions for such vehicles. Once this step is accomplished, existing funding pools at the Department of Commerce, Department of Energy and Department of Education offer promising opportunities for pilot programs.

**Reform procurement processes**

Current state and federal procurement rules can create undue barriers for social enterprises seeking government contracts. While procurement processes should always be designed to secure the best value for taxpayers, existing cost calculations often fail to take social impact into account, even when long-term benefits could be achieved by paying slightly more up front.

For instance, the federal government reimburses school districts no more than $2.70 per meal served, a price that makes starch-heavy, highly processed meals common in cafeterias across the country.\textsuperscript{xvii} But in 2006, a social enterprise based in Berkeley, California, set out to create healthy,
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low-cost school meals from whole, unprocessed ingredients. Meals from Revolution Foods cost about $3 per meal, slightly more than the current federal payment, but offer much higher quality — and the potential for creating lifelong healthy eating habits. The federal government already has the authority to take quality into account and this example underlines the importance of doing so.

**Government as a regulator**

Government has an important role to play in setting rules and guidelines for the impact economy. Clear standards and legal definitions can help guarantee transparency, investor certainty, and measurable social impacts.

**Create legal definitions for social enterprises**

A lack of legal definitions is holding back investors, entrepreneurs and philanthropists considering the social impact sector. Federal definitions for new structures such as benefit corporations, sometimes called B Corps, and low-profit limited liability companies, or L3Cs, will help encourage their formation.

To date, 23 states and the District of Columbia have authorized and created of benefit corporations, businesses that also seek to create social impacts. But differing rules and definitions from state to state may limit the scaling of such business models across the nation. A federal standard could help create a uniform definition of impact by which benefit corporations should be judged. It could also be pivotal to procurement reforms that cultivate the impact economy.

Similarly, several states have passed legislation permitting the creation of low-profit limited liability companies, for-profit businesses with the explicit goal of creating social value in addition to profits. The L3C classification is intended to help social enterprises attract investment from impact investors and from foundations through their program-related investment (PRI) activities. In addition to creating a federal definition for L3Cs, the Internal Revenue Service (IRS) should consider issuing clarifying guidance on what kinds of PRIs foundations can make with the goal of making it easier for foundations to engage in impact investment activities.

**Encourage impact investment through the tax code**

Energy partnerships, real estate trusts, and all manner of corporations enjoy various federal tax breaks, yet none are currently available for enterprises explicitly founded to promote social good. Obviously, tax code provisions are a powerful way to influence investor behavior, and many options are available for encouraging impact investment. The government could, for instance, create a tax credit for early-stage investments in social enterprises, potentially pairing it with the reforms to existing grant and capital pools discussed above.

The Low-Income Housing Tax Credit and New Markets Tax Credit are two examples of tax provisions that encourage types of impact investment. The Low-Income Housing Tax Credit is explicitly intended to spur affordable housing development; the New Markets Tax Credit was intended to be broader, but most of the capital used in qualifying transactions also goes toward real estate development. The government could consider reforming the New Markets Tax Credit to encourage investment in community building tools such as social enterprises, impact investment funds, revenue-generating nonprofits, and social impact bonds.

Of course, tax reform should be approached with caution. Before taking any action, the government should study whether specific changes to the tax code would actually encourage new investment in the impact economy, rather than rewarding investment that would have happened without incentives.
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Reform the Community Reinvestment Act
Since the 1970s, the Community Reinvestment Act (CRA) has encouraged commercial banks to make investments in historically underserved areas. Passed as part of a comprehensive law intended to end discriminatory practices against low-income borrowers commonly called “redlining,” the CRA requires federal regulators to assess banks’ lending in underserved communities.

The CRA has been updated and revised several times since its original passage. Regulators should look closely at the CRA and collaborate with community organizations and investors to determine how the Community Reinvestment Act can better facilitate impact investments that are evaluated by third parties, including social impact bonds and PFS agreements. This would encourage more commercial banks to invest in social impact, a useful incentive in the early development of the market.

Clarify definitions under the Employee Retirement Income Security Act
Complex federal standards make it difficult for pension funds to make impact investments. Revising the Employee Retirement Income Security Act (ERISA), the law governing pension fund investments, could encourage such investments.

A 2008 revision of ERISA regulations states that pension funds can make an “economically targeted” investment — one intended to produce economic or social benefits other than financial returns — only if it is one of “two or more investment alternatives… of equal economic value to a plan.” Many observers believe that this rule makes it unduly difficult for pension funds to make impact investments. The government should consider studying the potential benefits and risks of relaxing this rule and offering clarifying guidance on how pension funds can approach impact investments.

The experience of CalPERS, the California Public Employees’ Retirement System, offers important instruction to other pension funds. In 2012, CalPERS established its Targeted Investment Programs Unit, which seeks to achieve risk-adjusted returns on investments intended to have positive social, environmental or community impacts. As part of the program, CalPERS is seeking to establish a baseline carbon footprint for its real estate assets and works to increase investment in companies working in underserved communities.

Similarly, a range of public retirement funds have invested in low-income housing over the course of the last few decades. The New York Teachers’ Retirement System alone invested more than $160 million since 1990. These systems show that pension funds can be active impact investors while maintaining their fiduciary responsibilities; their programs should be carefully evaluated to establish leading practices for other funds.
Conclusion: A new economy

With promising new vehicles such as social enterprises, social impact bonds, impact investments, and benefit corporations, we have a chance to use public and private investment in ways that generate real, measurable social impact. If the impact economy is to reach — or top — $1 trillion by 2020, the federal government will need to encourage its growth and activity, set the rules of the road, and help bring together a diverse community of players.

The findings of the Social Impact Investment task force, and the conclusions of the national advisory boards associated to this initiative, will be critically important to this effort. Their findings should spur a new era of scholarship and policymaking. But many of the recommendations in this report can be acted upon even before the G8 process concludes. Doing so could help our nation see the dawn of a more responsible and sustainable economy.
Appendix: How we prepared this report

We began this report by conducting interviews with about 50 leaders engaged in thinking about and building the impact economy. These included impact investors searching for deals, social enterprises working in communities across the country, intermediary organizations, and government leaders. We spoke with representatives from different geographies, diverse sectors, and organizations of varying size.

We began each interview by asking subjects to explain how they define the impact economy. We inquired about public policies that could help them achieve their missions, and what they thought the government could do under its existing authorities to support the impact economy. Finally, we asked how their organizations measure social impact, whether they focus on a defined set of outcomes or seek to account for broader social benefits.

We shared the ideas that came from these conversations at the Social Capital Markets Conference (SOCAP) in September 2013. We vetted our conclusions with entrepreneurs, investors, and government officials. More than 80 leaders from the public, private and nonprofit sectors participated in this conversation, providing feedback and contributing new ideas.

We also presented some of our interview findings to a popular audience in a series of articles published in *Forbes* through the Skoll World Forum. The series offered an accessible overview of key issues in this space, from defining the impact economy to considering lessons the U.S. could draw from countries such as Australia and the United Kingdom.
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Shruti Shah is Director of GovLab within Deloitte’s Federal Consulting Practice. She is a performance management and public policy specialist with 15 years of experience in the public and private sector. Her specialized knowledge has been sought by Governments, International Labor Organization, World Bank and Organisation for Economic Co-operation and Development (OECD). Shruti holds degrees from Oxford University and the London School of Economics. She completed her training at the Kennedy School of Government, Harvard.

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Jitinder Kohli leads Deloitte’s work on public sector performance and innovation — and is a recognized expert on how a stronger focus on evidence can help government agencies and non-profit organizations improve impact. Until late 2012, he was a resident Senior Fellow at the Center for American Progress where he was one of the pioneers of the concept of Social Impact Bonds in the United States. He worked closely with state and federal government agencies including the White House to help them define the concept and adapt it to the American context.

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