

EXECUTIVE SUMMARY

ESTABLISHING SOCIAL BUSINESS FUNDS TO PROMOTE SOCIAL GOALS

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About the Koret-Milken Institute Fellows Program

The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

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Social business, the “fourth sector,” is a developing phenomenon in Israel and around the world as the use of business activity to promote social goals has become an important issue for policy makers, philanthropy and entrepreneurs in recent years. The purpose of this study is to lay the foundation for establishing a government program to encourage these businesses.

This study offers a theoretical analysis of the social-business phenomenon in an attempt to explain why the government should encourage this sector. The combination of business and social activity is not trivial. The standard concept behind business activity is “profit maximization,” while profits gained later can be used to achieve social goals. Why then should the government encourage businesses to sacrifice profit to achieve social goals?

The answer is that, in certain areas, the combination of business activity and social goals has the potential to achieve better outcomes. Three main reasons underscore this claim. First and foremost, the business activity itself often best serves the social goal. The clearest example of this is in employment of the disadvantaged population. Treatment of this population as regular employees, and not “patients,” can make a significant contribution to their rehabilitation process. Second, the ability to achieve social goals mainly on the basis of earned income reduces the organization's dependence on philanthropy and government support, lowering the uncertainty regarding future cash flow and allowing them to develop a strategic social plan. Third, the assimilation of business strategies in an organization can result in more effective management. These factors lead to the conclusion that, in relevant areas, there is an advantage to providing social product by giving up financial return within a social business rather than maximizing profit and later donating (or paying taxes) to finance social activities.

An analysis of the main characteristics of the fourth sector in Israel shows the development of this sector can make a significant contribution, especially in integrating disadvantaged populations into the labor market. The fourth sector can not and should not replace the third sector in all important activities, but development of the fourth sector can help with expanding the capital resources currently available for solving social problems. The ability to broaden funding sources depends largely on the ability of investors with different preferences (social and financial) to cooperate with each other. The trade off between social and financial return, which is done by social business, does not enable investors who are interested only in financial return (such as a commercial bank) to invest in social business. Therefore, these businesses rely primarily on philanthropic and government investment (“social investors”) and face the same limited sources of capital as third-sector organizations. Cooperation between social investors and investors who are interested in financial return can expand the capital sources available significantly. This cooperation can be accomplished by establishing a mechanism in which social investors minimize the risk for commercial investors.

There are, however, various constraints for these mechanisms, including the ability to combine tax benefits for donors and economic yield for investors. Social business can choose to unionize as a

non-profit organization, which will help the donors receive tax benefits, but a non-profit organization cannot distribute profits to investors who are interested in economic yield. On the other hand, a social business that incorporates as a limited company may distribute profits, but donors will not be eligible for tax benefits. Furthermore, in addition to the legal barriers faced by this collaboration, the fact that this is a relatively new field makes it difficult to coordinate expectations among investors, donors and social organizations. Lack of precedent makes it difficult to assess what economic and social returns can be expected from social business, which, in turn, makes it difficult for regulators to adapt the existing regulatory framework to the social-business phenomenon.

Based on those barriers, this study recommends the establishment of a social business investment fund, which could serve as a catalyst for development of the fourth sector. Such a fund could encourage the cooperation required between different investors while reducing the risks and creating a safe regulatory environment for of all parties involved and creating precedents that will help other funds to follow. Three key principles underlie the proposed model for establishing such a fund.

- 1. Pooling resources:** The corporate structure of the fund needs to enable a combination of three sources of capital (government, philanthropic and business sector) with philanthropic money and government money providing a safety net for the business sector investment.
- 2. Private-Equity model:** The fund manager's job is not just to provide money, but also to help with capacity building as social organizations do not always have the business skills needed to run a successful social business. The fund must provide the necessary professional escort when required.
- 3. Balance between economic and social returns:** A social-business fund is actually a social business itself. The incentives for fund performance should balance social return and financial return. The fund should adopt a clear methodology to monitor the social-bottom line, which will help deal with concern that the economic incentive will harm the social goal.

Government involvement in the establishment of the fund will help make the necessary coordination. Several governments have acted similarly in the past few years and established specialized investment funds for social business. In Israel, there also are examples of government-investment funds designated for certain areas. For example, in the 90s the "Yozma" program made a significant contribution to the development of the venture-capital industry in Israel. With respect to development of the fourth sector, establishment of the fund is not just for encouraging the sector, but also an investment in areas that exist in the core responsibility of the government, such as the rehabilitation of disadvantaged populations.

During the year this study was written, the Roundtable in the Prime Minister's Office explored ways to promote the social-business sector in Israel. As part of this effort, the National Economic Council examined various options for the establishment of a government social fund, which led to the publication of a Request for Information (RFI) for the establishment of "social enterprise fund." This,

hopefully, is a first step toward establishment of the fund.

The potential for the government, the largest social investor in Israel, is large and it should have an interest in examining new models for investment that hold the potential to raise the quality of social services. The establishment of the social-business fund involves a one-time investment that will help create a “social business market” operation which will continue to generate social return without the need for further government support.

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