Matthew Bishop and Michael Green

The Capital Curve for a Better World

The world isn't short of good ideas. The challenge that confronts every nation on earth is how to weed out the good from the bad, and then exploit the full potential of the good ideas and turn them into social innovations that can change the world for the better. For too long we have relied on the bluster of political debate and the logic of the pork barrel to decide on the best way to run our schools, stop killer diseases like malaria, or figure out how to avoid a climate change catastrophe. Given what is at stake, something has to change. Fortunately that is starting to happen.

The world is in the middle of a fundamental rethinking of this process of social innovation, with the goal of making it far more efficient and effective than ever before, through a movement that we call "philanthrocapitalism." The best business brains of our age are turning their attention to doing good, using not just their business skills but, in some cases, their businesses. One of the most important tasks they face is figuring out how to finance the growth of a good idea into a world-changing social innovation.

The "capital curve" for commercial businesses as they move from start-up finance to venture capital and, finally in some cases, the public debt and equity markets, is now well understood. Overall, the finance sector does a good job of matching the right kind of capital to the best prospects for profitability. The social sector needs an explosion of innovation and new thinking to follow suit, including developing its own well-functioning capital curve. This process, in which the philanthrocapitalists have a crucial role to play, will require a wide-ranging debate about the respective roles of for-profit, government, non-profit and philanthropic capital, so that these sectors work together more effectively in ways that play to their strengths and minimize their weaknesses.

Philanthrocapitalism is behind the growth of mission-related and impact investing that could lever hundreds of billions of dollars of new financing for social environmental projects. It is in the efforts of traditional non-profits, such as

Matthew Bishop and Michael Green are the authors of Philanthrocapitalism: How Giving Can Save the World. *Bishop is American Business Editor of* The Economist. *On Twitter he is @mattbish. Green is a writer and consultant.*

microfinance lenders, to tap the for-profit capital markets. It is in the emergence of inspiring conferences about social capital markets, such as SoCap. It is in the innovative partnerships developing around strategies for sustainable profits between for-profit businesses, such as Wal-Mart and Kohlberg, Kravis and Roberts, and non-profits, such as the Environmental Defense Fund (and not just as public-relations window-dressing but as a part of their core money-making strategy). It has even crept into government, with the Obama administration's establishment of a White House Office of Social Innovation to find successful ideas for social services from the non-profit sector and scale them up. And so on, and on.

The growing importance of social entrepreneurs, barely heard of a decade ago, is one of the leading indicators of this emerging new approach. These are people who specialize in the start-up phase of the execution of socially innovative ideas, the counterparts of the entrepreneurs who form the early-stage for-profit businesses backed by angel investors and venture capitalists. The challenges they face are arguably far harder than those confronting commercial entrepreneurs, not least because the primary goal of a social entrepreneur is not to generate revenue and profit, but to generate less financially tangible but socially more valuable returns on capital. That increases both the difficulty and the importance of creating an effectively functioning social capital curve.

The term "social entrepreneur" reflects a movement away from the traditional bifurcated view that business and business methods are for the for-profit world, whilst donations and government drive social innovation. It is about combining the business person's focus on efficiency with the social crusader's desire for a better world. It is the emergence of these social entrepreneurs that, according to Bill Drayton, the founder of Ashoka, holds out the promise of a productivity miracle in the social/citizen sector, which has long lagged behind the productivity of the for-profit business sector (even allowing for the recent economic crisis).

Ashoka, a network dedicated to supporting social entrepreneurs, has played a crucial role in improving society's understanding of the four-stage social entrepreneurial life cycle: apprenticeship, launch, take-off ("an extended period in which entrepreneurs consolidate their organizations and continue to refine and spread their ideas until they become widely adopted"), and maturity (when "entrepreneurs have had demonstrable impact on their fields").

The management challenges presented by each stage have been increasingly well-understood in recent years, not least by Ashoka. Drayton thinks that "the moment of "greatest magic and maximum vulnerability", is at the take-off point, when, without the right help, so many good ideas either wither and die or get stuck as isolated "islands of excellence". More recently, the management challenges of more mature social organizations, such as leadership succession and remaining innovative, have also been better understood. Specialized consulting firms such as Bridgespan and non-profit arms of mainstream consultancies such as McKinsey and Monitor have emerged in recent years to tackle these new problems of successful, but not successful enough, organizations.

Yet improving management and nonprofit governance is only part of the revolution that is needed. The next frontier in raising the efficiency of social innovation has to be the capital markets for good.

WHERE THE MONEY IS

Over the past few decades, our understanding of how to finance the growth of a good business idea into a world-beating company—say, Google—has improved massively. The efficiency of the capital curve that goes from angel funding via venture and mezzanine to publicly traded corporate debt and equity, though still not perfect, has improved considerably. By contrast, our understanding of how to finance the growth of a good idea into a world-changing social innovation, though better than it was 25 years ago, lags far behind. There is no easy fix. The for-profit capital markets are based on thousands of innovations that have helped bring the right investors together with the right investees. A concerted effort is now needed to design an effective and efficient capital curve for social innovation.

For a regular entrepreneur, the financing question is essentially about extracting money from for-profit investors and from customers who will pay for the products and services that the start-up produces—after the initial seed help from what Amar Bhidé, author of *The Venturesome Economy*, calls the "three Fs" (friends, family, and fools), and perhaps some extra pennies from government enterprise grants. The social entrepreneur with a good idea, by contrast, is often likely to focus on raising money from philanthropic investors who do not expect a profit. The social entrepreneur may also look ultimately to government to be her biggest paying customer.

Yet in recent years, the social sector has seen a growing and increasingly important role for for-profit investors and paying customers for social entrepreneurial businesses that also needs to be incorporated into the social innovation capital curve.

The challenge in driving more efficient social innovation is to figure out which forms of money—grants, debt, equity, government funds, for-profit funds, paying customer—are most effective at which stage along the journey from good idea to having massive social impact. The systems then need to be put in place to ensure that the resources that exist are available to the most promising ventures at different critical junctures. (In commercial technology entrepreneurship, a lot of attention has focused on the early "funding gap" between invention and market-ready innovation. Alas, we suspect, there are currently funding gaps all along the social capital curve.)

The new social innovation capital curve requires an up to date understanding of the strengths and weaknesses of each of the different sectors with money and resources—for-profit, government, non-profit, and philanthropic. This will then allow us to focus on how to get these sectors to work together more effectively in ways that play to their strengths and minimize their weaknesses.

Specifically, private for-profit capital has proved extremely effective at taking some kinds of innovative ideas to scale; in allocating capital to promising ideas, testing them quickly, sorting out the good from the bad; and in shifting capital from where it is underused to where it can be better used. However, as the recent global economic crisis has demonstrated, too often for-profit capital has been utilized in ways that focus on short-term gains at the expense of long-term goals. And it has frequently pursued private gains at the expense of, rather than for the increase of, the benefits to society as a whole.

Government—from the local council level to multilateral agencies—has huge advantages in driving large-scale change, through some combination of legal authority, democratic legitimacy, and the ability to raise taxes and borrow cheaply. Even in developing countries, where the quality of political leadership and administrative competence is (sometimes much) lower, despite a great deal of socially entrepreneurial innovation in these activities, only governments have the potential to provide universal access to a more limited list of basic services, such as primary education.

However, government often struggles to be innovative and take risks. (Politicians have to be re-elected every few years, which makes them wary of anything that costs money but could fail, or only pays out when it benefits their successors.) Government can also be extremely ineffective, especially when compared with the for-profit capital markets, in shifting funds from existing uses to new uses with a higher value. (Political processes tend to give a stronger voice to those who benefit from how government funds are currently spent than to those who might benefit one day from a risky new idea.) When it works with outside organizations, government often prefers shorter-term funding rather than long-term capitalization of new initiatives.

The non-profit/philanthropic sector has a decent record of funding innovative ideas in the early stages of putting them into practice. However, non-profits have tended to remain small and inefficient, especially by comparison with for-profit companies. They often have little choice but to rely overwhelmingly on short-term funding, which tends to be extremely expensive to raise (especially when it is in small amounts from the general public). Large-scale philanthropy has the potential to provide the long-term, high-risk capital that social innovation often needs, but too often is risk-averse and uses short-term project financing rather than providing innovative start-ups with philanthropic equity. Online crowd-sourced donations channelled through websites such as GlobalGiving also have an increasing role to play.

Each of these sectors has great strengths to bring to the capital curve needed to build a better world. Yet often there are significant barriers in the way of these sectors collaborating effectively with each other to bring a good idea to fruition. Laws, tax and fiscal policies, and organizational and societal cultures currently all too often work together to emphasize the differences between non-profit, for-profit, philanthropy, and government. This tends to keep them in their silos rather than to encourage the smooth and timely transition between different sorts of money that is the essence of a well-functioning capital curve. These barriers urgently need to be broken down.

Describing the capital curve for social innovation can help, not least by addressing the widespread misunderstandings that the different sectors have of each other. Government, for example, often tends to view the philanthropic/non-profit sector more as a source of cheap funds and other resources than a source of socially entrepreneurial innovation. For-profit companies often look at partnerships with non-profits as a public relations activity rather than as an opportunity to improve their long-term profits through win-win collaborations that combine the financial clout and organizational reach of the corporation with the deep insight into social change of the non-profit. Non-profits are too often happy to take the money from either or both and chug along.

The result is so many missed opportunities for the sectors to work together and add value to each other. Cultural norms and legal restrictions have often held back institutional investors (including philanthropic endowments) from urging the companies they invest in to focus more on long-term value creation and profit maximization. Philanthropic endowments have only slowly started to see the potential to achieve their missions by investing in securities that help the organizations they back to achieve social goals while offering below market but above zero financial returns. Governments have often denied the private sector, both for-profit and philanthropic/non-profit, a meaningful seat at the table at high-level discussions of how to solve the biggest problems facing the world (while often allowing the for-profit sector to "buy" access to governmental processes through lobbyists and campaign finance).

RISKS AND RETURNS

The for-profit world didn't crack the capital curve question because it is innately smarter; the for-profit capital curve is just easier because it involves a fairly straightforward combination of financial risk and financial return. At one end of the curve is the high-risk, high-return combination provided by angel investors and venture capitalists; at the other is the low-risk, low-return mixture of the investment-grade bond investor.

The social innovation capital curve is far more complex because of the difficulty of measuring the social return on investment. Philanthropists and governments are both looking for social returns, with governments, it is widely understood, having much less appetite for risk than philanthropists. So far, so straightforward. That would suggest a capital curve in which philanthropists take on the role of venture capitalists (hence the term "venture philanthropy"), funding ideas with high risks but potentially high social returns, while governments focus on scaling up social innovations that have been proven.

However, the difficulty in measuring social returns means it is hard to say with much confidence whether that is what either philanthropic foundations or governments actually do. Indeed, there are plenty of reasons to suspect that they do not, due to the personal risk-aversion of foundation trustees and elected politicians and the fact that a lack of data makes it easy to settle for business as usual rather than the hurly-burly of innovation.

There has been much work done over the years to try to measure more rigorously social impact and social returns on investment, through triple bottom lines, blended value etc, much of it pioneered by Jed Emerson (who has given valuable intellectual input to this article). It may never be possible to design data for social investment that are even as rigorous as profit is as a measure of success for the business world (nor, indeed, is profit the perfect measure of successful capitalism, as the financial crisis demonstrated). Yet there are plenty of reasons to believe that considerable improvement can be made on what passes today for measuring social impact to turn it into a genuinely useful tool for allocating social capital.

The most important first step will be to get agreement, as far as is possible, among those who are already committed to social innovation to start using some common definitions. At the moment, relatively trivial differences in, say, the measurement of environmental impact are frustrating any meaningful comparative analysis.

It may only be a baby step but there was an extremely encouraging development in September 2009, when a group of prominent investors committed to social innovation launched the Global Impact Investment Network (GIIN). Among GIIN's founding members were giant philanthropies such as the Bill and Melinda Gates Foundation and the Rockefeller Foundation, mainstream financial firms such as J. P. Morgan, Citigroup and Deutsche Bank, Generation Investment Management (a green-tinged fund management firm co-founded by Al Gore) and innovative philanthrocapitalistic hybrids such as Acumen Fund, which invests philanthropic dollars in for-profit firms in developing countries. The GIIN's goals include sharing information on what works and what does not, and agreeing on common language and measures of performance. One way it will do this is through the PULSE performance measurement system developed by Acumen, Rockefeller and the philanthropic arm of Google.

If GIIN can build a consensus among some of the big hitters in the social investment world about how to measure what works, we can hope that this will help to dispel much of the muddle and confusion that holds back social impact measurement today.

GETTING AHEAD OF THE CURVE

Better measurement of social impact should lead to a better fit of capital to social innovation, as money naturally flows more easily to where the demonstrably best ideas are. But there are several other ways in which the functioning of the capital curve can be improved—ways that are already starting to be put to work.

The first is the rise of what we call "virtue's intermediaries", which play an equivalent role in the world of social innovation to that of the financial intermediaries of the for-profit world. This idea has been attacked superficially in the aftermath of the financial meltdown of September 2008, characterized as arguing that the social sector needs "Lehman Brothers to the rescue". But although the mainstream financial sector can certainly do better, it is hard to fault the efforts of their counterparts in the social sector. These range from the likes of Echoing Green, which provides seed capital to social entrepreneurs, and the Non-Profit Finance Fund, which provides loans and growth capital, to Sea Change Capital, which raises equity-like capital for non-profits, and New Philanthropy Capital, which does research on which non-profits offer the greatest social bang for the buck. (It would also be desirable to see the emergence of the equivalent of mergers and acquisitions advisors to broker the sort of organizational combinations that rarely occur in the non-profit world.)

The greatest weakness of these "good-brokers" is that they are underfunded, not least because philanthropists and indeed governments too often regard investing in infrastructure as inferior to funding programs that have a direct impact on the needy. However, the infrastructure of virtue's intermediaries may actually ensure that those direct programs deliver a far higher social return on investment—in which case they would be a high impact social investment.

The second area is to accelerate the ability of some ideas to move from relying on philanthropic capital and government grants into a for-profit activity that can be taken to large scale by the for-profit capital markets. Here, microfinance demonstrates the possibilities. Over 30 years it has transitioned from pure charity into an industry that now includes many for-profit financial institutions, which serve millions of people who were previously denied access to basic financial services. True, this evolution has not appealed to some microfinance pioneers, most notably Nobel Peace Prize-winner Muhammad Yunus. Yet there is little doubt that tapping the for-profit capital markets has enabled this good idea to reach a far greater scale far more quickly than would have been possible by relying on charitable funds or foreign government aid.

A more efficient capital curve could potentially achieve similar results in other bottom of the pyramid services for the poor, in areas such as basic education, clean water supply, and health care, but far faster. Philanthropic funds could be used deliberately to design and test business models that could be scaled up by for-profit capital, instead of chancing upon such a model, as happened with microfinance. Ignia, a new investment fund started by Alvaro Rodriguez Arregui and Michael Chu, and backed by philanthropists such as Pierre Omidyar, is attempting to pioneer in several bottom of the pyramid sectors this accelerated movement along the capital curve from philanthropy to for-profit.

The third area is to improve the transition along the curve from high-risk, high-return philanthropic capital to large scale, less risk-tolerant government funding. One important initiative is the establishment of the White House Office of Social Innovation and its associated Social Investment Fund. The goal is to explicitly search out social innovations that currently work on a small scale and to grow them rapidly with government funds to maximize their social impact. This will not be easy—New York City, under its philanthropist mayor, Michael

Bloomberg, is probably the best example so far of putting this idea into practice—and the eyes of the world will be on this promising American experiment to see if it can be replicated elsewhere.

Another useful development is the rapid increase in the number of "partnership offices" to work with at all levels of government—from multilaterals such as the United Nations, which established an Office of Partnerships in 1999, to the national level, such as the office created by the President of Liberia to coordinate NGO activities in the country, to local mayors such as Cory Booker in Newark, New Jersey, who established a philanthropy office in City Hall. Maybe politicians and bureaucrats are starting to see the potential in partnerships.

Another opportunity is the use of financial innovation to provide market incentives for social innovation using government capital. Measuring social impact better allows those who care about social impact to put their money where their-mouth is, creating an incentive for innovators to deliver novel solutions by paying them when they deliver. Traditionally, governments have been the main source of this sort of funding for social outcomes, but often they have spent their money inefficiently, delivering services themselves in ways that are closed to innovation—a tendency that has only somewhat been reduced by the global privatization wave of the past 30 years. For government, how much it spends on a problem has too often taken precedence over what the money achieves.

More recently, however, governments and multilaterals have started to offer forms of financing that incentivize innovation. One example is the advance market commitments made by governments to buy certain drugs for the poor in the event that pharmaceutical companies develop them. This greatly reduces the risk to drugs firms of doing research with a high potential social impact but, before the advance market commitment, a potentially low or uncertain financial return.

Another interesting new idea is the social impact bond being developed by Britain's Social Finance, another new social investment bank. The idea is to attract private capital into solving a deep-rooted problem that is soaking up public money. Take, for example, re-offending by released prisoners, which costs the British government millions of pounds a year. A social-impact bond could raise money to pay for the expansion of organizations with the expertise to reduce re-offense rates. The more money the organizations save the government, the higher the return the bond would pay investors. This goes beyond a standard public-private partnership, which is expected to provide the same service as the state, but more cheaply. The social-impact bond would reward better social outcomes and not merely cut costs.

Social Finance thinks that the social-impact bond could be tried out in several public services. Besides being used to tackle reoffending, it could reduce the need for children to be put in residential care or improve community-based health care, easing the strain on hospitals. The key is to measure performance clearly, so that contracts can be enforced.

A fourth need is to improve the legal and fiscal context in which social innovation takes place. This agenda ranges from the tax treatment of charitable giving to the legal treatment of different types of activity. There is growing interest in making it easier for activities to transition from non-profit to for-profit, and to stay in hybrid organizations that can make some money but are not obligated to profit maximize.

Other countries should follow the example of Britain, which in 2000 created a Social Investment Taskforce, made up of financiers, non-profits, and government officials, to examine how to improve the social investment process. It came up with some good ideas, not all of which have been implemented and some of which can be improved on. Nonetheless, every country could benefit from its own social investment taskforce to work across the old sectoral boundaries and find new solutions.

Indeed, it would be great if countries competed with each other to create the best environment in which social innovation can happen. Many of the ideas in this article were mulled over in November 2009 by members of the World Economic Forum Global Agenda Council on Philanthropy and Social Investment. This group proposed that the World Economic Forum (WEF) should publish an annual Social Competitiveness Report. This would rank countries according to the effectiveness of their legal, fiscal, and cultural environment with regard to social innovation.

This would resemble the Global Competitiveness Report that the WEF has published for decades, which ranks countries according to how favorable a place they are to do business. This report, it is widely agreed, has encouraged countries to compete to raise their ranking by improving their tax, legal, and cultural frameworks for business. Similarly, a Social Competitiveness Report would drive the creation of a systematic body of knowledge about the current structure of legal, tax, and other policies toward social innovation, and about what works best.

We live in a rapidly-changing global economy where innovation has lifted millions of people and whole countries out of poverty. Imagine if we could translate that ability to take new ideas to scale in the markets for profit to the markets for social value. Competition has to be the key. The World Economic Forum's Social Competitivevness Report could drive social innovation higher up the political agenda as countries compete to be better place to do good.