POSITION PAPER FOR G8

GOVERNMENT & IMPACT INVESTING

impact Lab
INVESTING

SDA Bocconi

Government & Impact Investing

Veronica Vecchi, Francesca Casalini, Niccolò Cusumano, Manuela Brusoni

Impact Investing Lab, SDA Bocconi School of Management

1. Introduction

Impact Investing is growing fast as a market niche where new business models, often based on "reverse strategy"(Vecchi, Brusoni & Cusumano, 2014) and social innovations can extraordinarily increase the enterprise value for the benefit of stakeholders, and therefore shareholders, and the community at large.

Different are the drivers beyond Impact Investing, with diverse influences:

I. the massive liquidity available and investors in search for alternative assets[1];
II. companies turning towards more strategic approach to their Corporate Social Responsibility;
III. social enterprises looking for access to capital to sustain their development.

Even if their role has been less explored so far, even Governments may become relevant stakeholders of the Impact Investing efforts. Undoubtedly, they are interested in its potentiality to sustain economic development, through new businesses creation and employment opportunities, especially for young people. For example, in Europe the rate of unemployment among youth is quite high[2]. Therefore, Governments can stimulate the development of Impact Investing actions through different policies, aimed at support the demand side (i.e. the generation of the deal flow of businesses) and/or the supply side (i.e. the creation of impact investing funds and the attraction of capital). They can choose among different policy actions to reach these goals, in the majority of case already experimented in the past for the (innovative) start – ups and small businesses. Actually these policies continue to remain the core of the political agenda in many Countries.

As Impact Investing often works in those sectors where the welfare state or more in general the public sector is unable to cover the more and more diversified needs of citizens (i.e. healthcare, elderly care, education. unemployment), especially in developed countries, the Government may act as a regulator.

Government can also become the trigger of impact investing, through the so called public procurement for innovation or public – private partnership (PPP), so far mainly conceived for the development of major infrastructure projects. However, PPP can even represent a way to experiment alternative approach and players to deliver public

[1] Global assets under management rose to a record high of $64 trillion in 2012 and are estimated to rise to roughly $102 trillion by 2020 (BCG, 2013; PwC, 2014).
[2] In May 2014, 5.2 million young people were unemployed in the EU-28 area, which represents an unemployment rate of 22.2% (European Commission, 2014).

services, thus paving the way to a larger role of businesses aimed at generating impact in sectors like those cited above.

2. Setting the framework: Business Government Relations

Indeed, beyond impact investing the relation between Government and Businesses (often referred to as Business Government Relations - BGR) has become of increasing interest for scholars and practitioners.

Especially in the US, BGRs are mainly referred to the recognition that Government can influence business performance and therefore public policies must be embedded in the strategy definition. This approach often couples with the lobbying practice.

Some authors, recognizing the importance of Government for the success of business or solely of a specific strategy (indeed Porter described the Government as a factor influencing the 5 forces), introduced the concept of non market or non competitive strategy as opposed to market strategy. Despite the efforts (see Baron, 1995) to reconcile the two strategies under a unique and hybrid approach, in the literature and in the practice BGR still means“lobbying and influencing”policy maker and regulator, and dichotomies still exist between market and non market arena.

In the European arena, where the role of the Government is more pervasive, BGR embraces a wide number of relations and situations, both in the political arena (policy making activities) and in the market arena. Therefore, BGRs have been sometimes conceived as Public – Private Partnerships, more and more used across countries as a consequence of the evolution of the State from a Welfare model to other lighter models, often described as Public Governance and Regulator State.

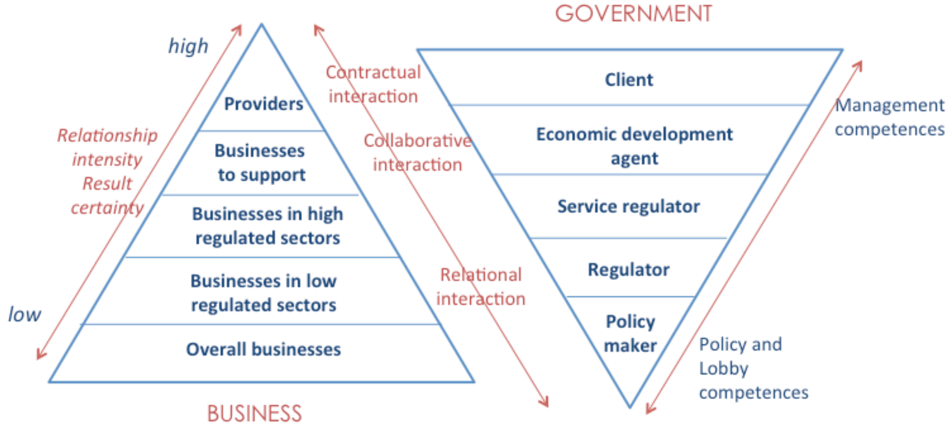
However, the different degrees of interaction and related definitions do not capture all the nuances that exist in the intersection between the public and the private sector, especially when the aim is to support the development of a nascent sector, as is the case of Impact Investing.

It is therefore useful to adopt a wider and less prescriptive BGR’s concept, to consider relations and consequently activities that take place neither in the political arena nor in the pure market arena. This is the case of incentives and business services to support entrepreneurial development, a field characterized by a network governance approach, where local, national and supranational (i.e. the European Union) actors work with social and economic players at different institutional levels, with several forms of interaction.

Actually, BGRs should take into consideration weaker forms of collaboration between Business and Government, very often initiated by businesses, to enforce political, social and civic rights or to help Government to pursue social interests. These actions can be defined as corporate citizenship or CSR actions. They can be part of the strategic agenda of several types of companies, not only those linked to the Government by market relations or those working in high regulated sectors.

Figure 1 shows the wide spectrum of relations that can occur between Government and Businesses.

Figure 1: Pyramid of relations between Businesses and Government



Source: Vecchi et al., 2013

3. Impact Investing & Governments: the pyramid of relations

In order to explore and analyze the possible relations between Government and Impact Investing, we refer to Figure 1.

3.1 Government as policy maker, regulator and referee

Impact Investing sectors are characterized by the production of goods and service with relevant societal implications and in many cases in business-to-consumers sectors, where the public regulation is (or should be) high, especially to assure consumer protection. In these sectors, but not only, given the increasing role that (local and national) Governments and Supranational Organizations have on business environment, companies generally try to influence the regulator or policy maker to define rules to sustain their own competitive advantage.

As described by Watkins et al. (2002) in the famous book "Winning the Influence Game", companies play in two different games:

- *Value-net games*, which have to do with cooperation and competition among businesses;
- *Public interest games:* which pit coalitions of businesses, and even entire industries, against nonbusiness organizations like unions, consumer groups, and environmental organizations.

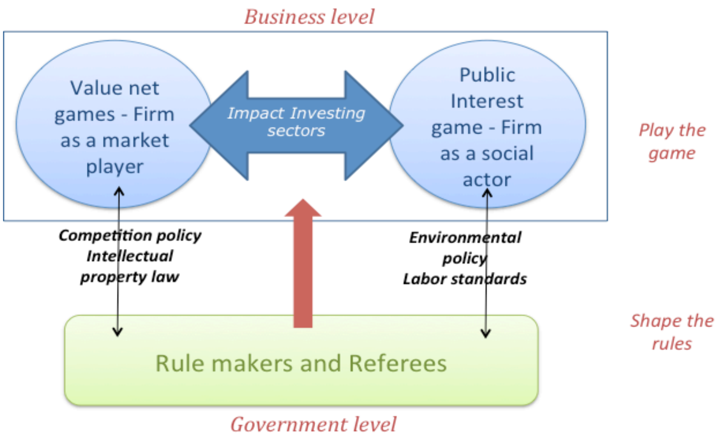
Governments play relevant roles in most businesses' value-net games. Public interest games primarily concern industries with a significant impact on public health and safety, such as oil, chemicals, tobacco, pharmaceuticals, automobiles, and, increasingly, collection and use of consumer data. But some games, like those involving employee benefits or privacy on the Internet, potentially affect all businesses (Watkins et al., 2002). However, we can say that the majority of impact companies play a public interest game and for them there is a strong connection between the strategies played in both games.

SDA Bocconi

Referring to the relation between Governments and traditional companies, the influence game can be illustrated as in Figure 2 by the two double-vertical arrows (linking the two games played at business level with the Government level).

With reference to Impact Investing sectors, where companies deeply combine strategies played in the two games, as a matter of their identity or DNA, it can even be possible that Governments can create more favorable rules (i.e. taxation, self – regulation norms) influencing both games, as they recognize the role played by these companies in the public-interest game.

Figure 2: The influence game between Government and Business



Source: adapted by Watkins et al., 2002

3.2 Government as economic development agent

Government should sustain impact companies not only as integrated player in the value-net and public interest games, and therefore through legislations and regulation, but also because of their impact on economic development. Under this approach, impact investment can become a specific track of entrepreneurial policies.

Governments generally sustain the creation and development of new companies through three different approaches:

- system actions
- business support services and
- financial aid.

Actually, as discussed by Vecchi, Brusoni & Borgonovi (2014) these three approaches can be included into a three-step process aimed at empowering the execution of entrepreneurial policies, which generally take place at local level.

The system conditions represent hygienic or contextual factors, i.e. necessary elements to begin effective development programs, also of an entrepreneurial nature. Once the fertile ground has been created, it is possible to move to the second phase: the provision of services, which also includes training. Business support services have the main objective of launching a business (start up) or improving the competitive capacity of those existing. Once the so-called business "deal flow" has been created, then it is possible to enter the third phase in which authorities can devote resources to financing businesses in a selective and incentivizing manner.

Below we outline the nature of these three phases in more detail.

Among the system conditions, of particular importance are: adequate and lean rules (Porter, 2000); leadership of public authorities based on the effective ability to respond to problems and to generate results (Malecki, 2002; Rondinelli, 2003; Ansell and Gash, 2008) and a"co-evolution of public and private players. Co-evolution can be identified as the ability to listen to the enterprises' and more in general the stakeholders' needs and as the definition of integrated (public-private) paths for development. Business needs' understanding is rare within entrepreneurial public programs but it has proven essential for their effectiveness. Mason and Brown (2013) suggest also that it could be useful to employ champion entrepreneurs to support businesses in the analysis of their development requirements.

Business services are aimed at supporting enterprises in those activities (accounting and finance, marketing and commercialization) for which they don't have specific competences and for which the purchase of consultancy could be too expensive. These services could be delivered through dedicated agencies (such as development agencies); through business incubators (Pena, 2002; Mason and Brown, 2011) or private partners (Bennet and Robson, 2003). These services along with specific training support, even informal, are necessary to create a flow of high potential businesses, which could benefit from additional public support, such as financial instruments.

As for financial aid, public authorities should recognize the most appropriate facilities on the basis of business type and objectives. For example, subsidized loans, public-private venture capital funds and guarantee schemes can be more efficient alternatives to traditional grants, because they stimulate the private co-financing and the beneficiaries' commitment (Mason et al., 1996; Hallberg, 1999). However, financial programs should be the result of a well-planned integration of public and private sources of funding and not the result of random choices, as it is often the case (Oakey, 2003).

This process could be depicted as a flow of actions that take place in multi-stakeholder patterns: essential ingredients for the process to work are co-evolution and legitimacy, which must be verified and reinforced in the first phase. Therefore, the three phases identified here should not be interpreted and implemented in a mechanistic or unidirectional manner: taking time for assessing and listening to partners and beneficiaries of the interventions is important in order to identify possible improvements and activate a collaborative learning process (Ansell and Gash, 2008).

3.3 Public Private Partnership (PPP)

PPP is a quite broad term, which can assume different meanings. With specific reference to the Impact Investing sector we can consider the following main forms:

- Public procurement for innovation
- Service concession scheme

Public demand could drive private markets in the desired in a more effective way of direct subsidies to R&D (Geroski, 1990; Dalpé et *al.*, 1992; Dalpé, 1994; Edquist & Hommen, 1998; Edler & Georghiou, 2007; Aschhoff & Sofka, 2009). Public demand has, in effect, the potential to overcome barriers that prevent the diffusion of innovation such as: entry costs; lack of information or awareness; learning and adjustment costs; lock-in effects; path dependency and lack of network effects (Edler, 2007) and in general because it could allow the translation of unarticulated demands in proper market signals (Mowery & Rosenberg, 1979).

A number of typologies have been developed to categorize public procurement of innovation. These include: the end users of the goods and services procured (Edquist *et al.,* 2000; Edler & Georghiou, 2007; Hommen & Rolfstam, 2009); the type of innovation and the stage of the technology life cycle in which innovation is seen to occur (Edquist *et al.,* 2000; Edler *et al.,* 2005; Hommen & Rolfstam, 2009); and the combination of markets and technology of the goods and services procured (Uyarra, 2010).

Public procurement of innovation is a specific form of procurement, in which the tender rules (i.e. technical specifications, evaluation criteria) are set in a way to stimulate the generation of innovation in order to find the most suitable solutions (not available in the market) for the purchasing authority (per se or per its citizens).

As noted by Flanagan & Uyarra (2009) the current debate is limited in several ways: it downplays the varied nature of public procurement in terms of the wide range of types of goods and services procured by the public sector; second, it downplays the varied nature of innovation; and third, it downplays the multiple potential innovation effects of public procurement.

The two authors underline that defining procurement of innovation as the purchase of new or future products excludes innovation through the recombination of existing goods or services, innovation in the delivery of existing services, and exclude most process innovations (Flanagan & Uyarra, 2009). Moreover all those definitions focus only in the initial purchase, thus overlooking subsequent contract management activity. This kind of approach probably comes from a traditional perspective of public procurement as one-off activity where, carried out the tender and signed the contract, procurer and the supplier substantially end their interaction, besides common administrative activities such as payments.

At the opposite of private sector, public procurement rules prevent in principle the establishment of long-lasting relationship between buyer and supplier. Where the firm look at building a partnership with few selected suppliers, public authorities should address the whole market at each end of a contract (Arlbjørn & Freytag, 2012).

However new forms of partnership between public sector and private operators are emerging (Bovaird, 2006) under the form of Public Private Partnerships (PPPs).

According to the most common view and practice, a PPP is a contract between a public authority and a private company (or a consortium) aimed at producing and delivering a service for the authority itself or for a specific target of citizens.

Indeed, a public authority may deliver a service directly (in house) or through a private operator. If it choses the second option, it can decide to enter into a PPP agreement, often based on a concession contract. The following distinguishing features characterize a PPP:

- A mid – long term contract (generally from 3 year onwards);
- A payment based on performance;

- A share of risk between the public commissioning authority and the private company.

A public authority may choose a PPP for the following reasons, often known as "micro – economic benefits":

- Efficient and timely project delivery
- Whole life-cycle cost optimization
- Revenue innovation

> The microeconomic case for the PPP model resides in its ability to allocate risks more effectively than traditional procurement and thereby stimulate a clearer focus on the whole-of-life costs of projects (Savas, 2000; Wettenhall, 2003; Forrer et al., 2010; Engel et al., 2013). This may be achieved if, by bundling together a wide range of infrastructure-related activities within a single transaction, the PPP has greater potential for generating economies of scope or social innovation. In addition, because the projected costs and revenues of the private sector are subject to variation (risk), there are strong incentives to realise this potential. For example, the private sector's service delivery costs may be greater than those estimated at the point of contracts being signed, and these additional costs will give rise to losses for the operator. In addition, contracts allow for payments to be reduced if a part of the asset is unavailable for use or where the quality of services fails to meet contracted standards (in case of availability based PPP), or revenues may be under those expected if demand projections were wrong. As a result, the private operator has in principle strong incentives to (i) estimate costs judiciously before the contract is signed; (ii) manage costs diligently after the contract is signed; and (iii) ensure that services are produced to the contracted standard to avoid any reduction in revenues (Hellowell et al. 2014)

Here we refer mainly to PPP for service delivery, even if in many cases they can be aimed at delivering a so-called infrastructure – based service, where the investment is a relevant component of the contract. Actually, even in a service – based contract there may be an investment component, though residual. The private provider, in this case an impact company, can be paid for the service delivered (and the investment done) by service users or by the authority; a mixed payment can be foreseen in case users can't allow commercial tariffs or however tariffs that can be considered remunerative against the cost incurred. When the main stream of payments comes from the Authority, they can be conceived in two ways: availability charge (linked to the availability of the service, generally directly used by the authority, but it even possible that the service is used by citizens); shadow payments (linked to the number of effective users, so that the concessionaire retains wholly or in part the demand risk).

However, it is suggested to limit as much as possible forms of public grant (revenue or capital) in order to stimulate the social innovation necessary to match the social impact with the expected return and to avoid moral hazard situation.

The typical structure of a concession based PPP for service delivery is drawn in Figure 3.

Figure 3: Structure of a concession based PPP for service delivery

The emergence of this kind of partnership has pushed some authors (Zheng & Caldweii, 2008; Arlbjørn & Freytag, 2012; Erridge & Greer, 2002) to inquire if there's some kind of mutual learning and if it leads to innovation. Zheng & Caldweii (2008) in their paper noted that there's an asymmetry between the capacity of private and public partner in developing mutual learning and kick starting innovation processes, the previous appearing poorly equipped to maintain long-term/strategic capabilities at organizational level, depending in large extent on individual competencies rather then organizational ones. Public sector due to its fragmentation also lacks the capacity to transfer to knowledge among different organizations. However there are still too few studies on these aspects.

Social Impact Bonds, which are often considered a first approach to Impact Investing or at least a way to combine social and financial return, can be conceived as a form of PPP, where the main payer of the private operator is the authority and the payment is linked to the performance achieved (the saving against the past budget allocated by the authority to directly deliver the service). The stream of payments, thus based on the level of performance achieved, is used to pay the cost of the service provider and to remunerate the capital invested – the capital provided by investors through the social bonds. In this example, we can find the features of a PPP contract, as described above, and especially a payment related to the performance (with specific targets to be reached) and the transfer to the private operator of the so called operating risk, as described by the new EU directive on concessions (23/2014/EU). Actually, an operating risk is something more than a simple performance risk, which can be attached to each contract. It is the possibility that the economic operator will not recoup the investments made and the costs incurred in operating the works or services under normal operating conditions.

It is not strange that Social Impact Bonds have been conceived for the first time in the UK, the homeland of PPP as an alternative way to deliver services through the involvement of the private sector.

4. Concluding remarks

This paper has presented and discussed the main forms of interactions between Government and Impact Investing, in the framework of the BGRs literature and practice.

Actually, this approach is useful to understand the different forms of relations that go far beyond the general request of a supporting Government, which should approve a favorable tax system to sustain the development of the Impact Investing.

Impact Investing is a marriage of public and private interests (Bendell et al., 2011), as it combines a commitment to improving public welfare with the power and efficiency of capital markets (Clark, Emerson and Thornely, 2014). Therefore, a Government can:

- conceive a favorable legislation to recognize the Impact Investing economic and social value (as described in paragraph 3.1);
- develop initiatives and financial tools to sustain the development of Impact Investing companies as a way to tackle economic and societal development (as described in paragraph 3.2);
- design and implement PPP to leverage Impact Investing sector to increase the quality and the diversification of services for citizens and the community at large, also as a way to move progressively towards a role as service regulator (as described in paragraph 3.3).

SDA Bocconi

References

Ansell, C., & Gash, A. (2008). Collaborative governance in theory and practice. *Journal of public administration research and theory*, 18(4), 543-571.

Aschhoff, B., & Sofka, W. (2009). Innovation on demand - Can public procurement drive market succes of innovations? Research Policy , 38, 1235-1247.

Arlbjørn, J. S., & Freytag, P. V. (2012). Public procurement vs private purchasing: Is there any foundation for comparing and learning across the sectors? *International Journal of Public Sector Management , 25* (3), 203 - 220.

Baron, D. P. (1995). Integrated strategy. *California management review*, 37(2), 47-65.

Bendell, J., Miller, A., & Wortmann, K. (2011). Public policies for scaling corporate responsibility standards: Expanding collaborative governance for sustainable development. *Sustainability Accounting, Management and Policy Journal*, 2(2), 263-293.

Bennett, R., & Robson, P. (2003). Changing use of external business advice and government supports by SMEs in the 1990s. *Regional Studies*, 37(8), 795-811.

Bovaird, T. (2006). Developing new forms of partnership with the "market" in the procurement of public services. *Public Administration, 84* (1), 81–102.

Clark, C., Emerson, J., & Thornley, B. (2014). *Collaborative Capitalism and the Rise of Impact Investing*. John Wiley & Sons.

Dalpé, R., DeBresson, C., & Ciaoping, H. (1992). The public sector as first user of innovations. *Research Policy , 21* (3), 251-263.

Dalpé, R. (1994). Effects of Government Procurement on Industrial Innovation. *Technology in Society , 16* (1), 65-83.

Edquist, C., & Hommen, L. (1998). *Government Technology Procurement and Innovation Theory.* Linköping University, Department of Technology and Social Change. European Commission.

Edler, J. (2009). *Demand-based Innovation Policy.* Manchester Business School working paper, No. 579, http://hdl.handle.net/10419/50691

Edler, J., Georghiou, L. (2007). Public procurement and innovation – Resurrecting the demand side. *Research Policy , 36*, 949-963.

Edquist, C., & Hommen, L. (1998). *Government Technology Procurement and Innovation Theory.* Linköping University, Department of Technology and Social Change. European Commission.

Edler, J., Rigby J., Hommen L., Rolfstam M., Edquist C., Tsipouri, L., Papadakou M. (2005), Innovation and Public Procurement. Review of Issues at Stake, Study for the European Commission, Retrieved at http://cordis.europa.eu/innovation-policy/studies/full_study.pdf

Engel E., Fischer R., Galetovic A (2013), The basic public finance of public–private partnerships, *Journal of the European Economic Association*, 11 (1): 83–111.

Erridge, A., & Greer, J. (2002). Partnership and public procurement: building social capital through suppy relations. *Public Administration , 80* (3), 503-522.

Flanagan, K., & Uyarra, E. (2009). Understanding the innovation impacts of public procurement. *574* . Working Paper Series.

Forrer J., Kee J. E., Newcomer K. E., Boyer E. (2010), Public–Private Partnerships and the Public Accountability Question. *Public Administration Review*, 70 (3): 475–484

Geroski, P. (1990). Procurement policy as a tool of industrial policy. *International Review of Applied Economics , 4* (2), 182-198.

Hallberg, K. (1999). Small and medium scale enterprises: A framework for intervention. *The World Bank*.

Hellowell M., Vecchi V., Caselli S., (2014), Return of the state? An appraisal of policies to enhance access to credit for infrastructure-based public private partnerships, *Public Money and Management,* (forthcoming).

Hommen, L. a. (2009). Public procurement and innovation: towards a taxonomy. *Journal of Public Procurement , 9* (1), 17-56.

Malecki, E. J. (2002). Hard and soft networks for urban competitiveness. *Urban Studies*, 39(5-6), 929-945.

Mason, C., & Brown, R. (2013). Creating good public policy to support high-growth firms. *Small Business Economics*, 40(2), 211-225.

Mowery, D., & Rosenberg, N. (1979). The influence of market demand upon innovation: a critical review of some recent empirical studies. *Research policy*, 8(2), 102-153.

Oakey, R. P. (2003). Funding innovation and growth in UK new technology-based firms: some observations on contributions from the public and private sectors. *Venture Capital: An International Journal of Entrepreneurial Finance*, 5(2), 161-179.

Pena, I. (2002). Intellectual capital and business start-up success. *Journal of intellectual capital*, 3(2), 180-198.

Porter, M. E. (2000). Location, competition, and economic development: Local clusters in a global economy. *Economic development quarterly*, 14(1), 15-34.

PricewaterhouseCoopers (PwC). (2014). *Asset Management 2020: A brave new world*.

Rondinelli, D. A. (2003). Promoting National Competitiveness in a Globalizing Economy: The State's Changing Roles'. *Reinventing Government for the*

SDA Bocconi

Twenty-First Century, State Capacity in a Globalizing Society, Rondinelli, Dennis A. and G. Shabbir Cheema (editors), Kumarian Press, Inc., CT, 33-59.

Savas E. S. (2000), *Privatization and Public–Private Partnerships*, New York: Chatham House.

The Boston Consulting Group (BCG). (2013). *Global Asset Management 2013. Capitalizing on the recovery.*

Uyarra, E. (2010). *Opportunities for innovation through local government procurement.* Manchester Institute of Innovation Research. NESTA.

Vecchi, V., Brusoni, M., & Borgonovi, E. (2014). Public Authorities for Entrepreneurship: A management approach to execute competitiveness policies. *Public Management Review*, 16(2), 256-273.

Vecchi, V., Brusoni, M., & Cusumano, N. (2014). Impact Investing: an Evolution of CSR or a New Playground?. In Stachowicz-Stanusch, A. (edited by), *Corporate Social Performance: Paradoxes, Pitfalls and Pathways To The Better World*. Information Age Publishing, (forthcoming).

Watkins, M., Edwards, M., & Thakrar, U. (2002). *Winning the influence game: what every business leader should know about government*. John Wiley & Sons, New York.

Wettenhall R. (2003), The Rhetoric and Reality of Public–Private Partnerships. *Public Organization Review*, 3(1): 77–107.

Zheng, J., & Caldweii, N. (2008). An asymmetric learning in complex public-private projects. *Journal of Public Procurement , 8* (3), 334-355.

Main Sponsor

OltreVenture

with the contribution of

Bocconi Alumni Association

Assifero
Associazione Italiana Fondazioni ed Enti di Erogazione

IBAN®
Associazione Italiana degli investitori Informali in Rete
Italian Business Angels Network Association

Member of

GIIN
GLOBAL IMPACT INVESTING NETWORK

EVPA
EUROPEAN VENTURE PHILANTHROPY ASSOCIATION