MaRS | CENTRE FOR IMPACT INVESTING

Pre-Budget Submission to the
House of Commons Standing Committee on Finance
August 2014

With minor modifications, this submission draws directly from the forthcoming report of Canada's National Advisory Board to the Social Impact Investment Taskforce, launched by the G8 in 2013. This report, which builds on the 2010 report of the Canadian Task Force on Social Finance, will be published on September 15th, 2014. The MaRS Centre for Impact Investing (MCII) is the secretariat to Canada's National Advisory Board.

Executive Summary

The impact investment (or social finance) market in Canada is growing, but at a slow pace relative to its potential. Accelerating its growth could foster innovation, assist individuals and communities to realize improved social and economic outcomes, and result in better value for government expenditures.

Social challenges – from youth unemployment to homelessness and chronic disease – demand innovation, or they will increasingly represent a drag on the wellbeing of Canadian communities, the economy, and government budgets. Governments do not have the capacity to address these challenges on their own, particularly in the current context of fiscal constraint. Innovation in the social sector will require the resources, ideas, and local-level insights of a wide range of actors, from the public, private and non-profit sectors.

Focused on directing private capital into projects and ventures whose aims are to deliver measurable social outcomes, impact investment has the potential to foster innovation in the social sector. It can be used to develop and test new ideas that may effectively tackle social challenges, and to scale up those that work.

Investees often operate as social enterprises – non-profit, for-profit, co-operative or hybrid entities that use the sale of goods and/or services to advance a public benefit mission.

Federal government leadership is critical to unlock impact investment capital and support social enterprise development. Smart policy frameworks and investments would enable other actors – including non-profit and philanthropic organizations, entrepreneurs, fund managers, financial institutions, and intermediaries – to deliver positive social and economic impacts. Action is recommended in the following priority areas in the next two years, as part of a broader impact investment strategy:

1. Enable charity and NPO social enterprise activity.

2. Unlock foundation capital for impact investing.

3. Establish an impact investing matching program, paired with appropriate incentives.

4. Establish an outcomes payment fund.

These recommendations support all six themes identified by the House of Commons Standing Committee on Finance for this year's pre-budget consultations – in particular, supporting families and helping vulnerable Canadians, increasing the competitiveness of Canadian businesses (which include social enterprises), and improving Canada's taxation and regulatory regimes.

Barriers to social entrepreneurship and impact investment in the non-profit and charitable sector

The rules governing non-profit organizations (NPOs) and charities have not kept pace with the trends of social entrepreneurship and impact investment, which are increasingly regarded as valuable tools for more effectively and efficiently addressing social challenges.

Building on the Budget 2014 announcement of a consultation on NPOs, Budget 2015 should commit to revise the rules governing NPOs and charities, in light of the benefits of fostering social entrepreneurship, impact investment, and innovation in Canada's non-profit and charitable sector, including through the implementation of the following recommendations. These recommendations focus on the *Income Tax Act* (ITA) and related guidance.

1. Enable charity and NPO social enterprise activity.

NPOs and charities are key providers of social services in Canada. They also have a significant economic impact, with a gross domestic product contribution of $35.6 billion, or $100.7 billion including hospitals, universities, and colleges (2007 figures), a workforce of over two million, and more than two billion volunteer hours.

To maximize their social and economic impacts, many charities and NPOs are taking an entrepreneurial approach – engaging in revenue generating and capital raising activity to improve financial sustainability, develop and test innovative ideas, and grow successful services to scale. While social entrepreneurship has been evident in the sector for many years, the ITA and related guidance generally do not recognize the value of this activity, and may in some cases inhibit it.

a) Allow charities and a sub-set of NPOs with clear public benefit objectives to pursue certain related business activities on an income tax exempt basis, and to pursue other business activities subject to income tax.

This would provide charities and NPOs with increased flexibility to generate revenue for the purpose of advancing their public benefit objectives, while addressing concerns about unfair competitive advantage and mission drift.

b) **Allow charities to provide a private benefit where necessary to achieve a broader public benefit**, by clarifying relevant guidance.

Charities must be established for public benefit. Canada Revenue Agency guidance indicates that any private benefits must be minor and incidental to the organization's charitable purposes, and suggests that programs benefiting employers or particular individuals may not be permissible, even if they deliver improved social outcomes.

For example, charities should be allowed to support employer recruitment efforts when this would achieve better employment outcomes for disadvantaged populations and result in reduced unemployment.

2. Unlock foundation capital for impact investing.

The potential for foundations to act as early leaders in Canada's impact investment market is significant. Canadian foundations collectively manage about $45.5 billion. While they are required to direct 3.5 percent of their assets into grants each year (to meet their annual disbursement quota), the rest is generally invested with the sole aim of maximizing financial returns. Impact investing offers foundations the opportunity to align at least a portion of their investment portfolios with their charitable objectives.

Impact investment opportunities offer a range of risk-return profiles and can be considered as part of a balanced portfolio within existing policy frameworks. However, additional opportunities that are currently off-limits for foundations should be permitted through targeted legislative changes.

a) **Allow charities to invest in limited partnerships (LPs).**

Private foundations are prohibited from carrying on a business and other charities are discouraged from doing so. By reason of the legal definition of a partnership, a charity that invests in an LP is considered to be carrying on a business even if it plays no active role in the business, and even though investments are generally understood to provide passively earned income.

The barrier to investments in LPs is problematic from the standpoint of building Canada's impact investment market, as impact investment funds are often structured as LPs. This structure has also been used as a vehicle for investing in Social Impact Bonds.

b) **Allow charities to make below market rate investments, where appropriate to advance their charitable objectives**, in any form of enterprise or project.

Currently, foregone revenue resulting from an investment that was expected to yield a below market rate return is considered to be a charitable grant, which is impermissible unless the recipient is a qualified donee.

While it is important to recognize that many impact investments are prudent by traditional financial standards, impact investments for which no return or a below market rate return is expected are sometimes warranted. For example, early stage social enterprises can struggle to attract risk capital and may not be able to offer risk-adjusted market rate returns. In addition, tranched investing, in which certain investors take higher-risk positions that are not necessarily commensurate with return expectations, may be necessary to attract more risk-averse capital to worthwhile projects. This type of investment can be used to complement granting. In many cases, it will also provide a financial return.

For example, in the United States, the Bill and Melinda Gates Foundation has invested in early stage drug, vaccine, and health technology development, in some cases leveraging external capital from private investors that would not otherwise have been available by taking a first loss position or providing guarantees. These investments have been used to accelerate the development of innovative solutions to health challenges that disproportionality affect populations in developing countries, aligned with the foundation's charitable objectives. Canadian foundations should be encouraged to play a similar role in stimulating investments with positive social impacts.

Opportunities for catalyzing impact investment

From the Government of Canada's recently launched Venture Capital Action Plan, to the Government of Nova Scotia's Community Economic Development Investment Funds, to the joint investment by the governments of Canada and Quebec in the Fiducie du Chantier de l'économie sociale, initiatives designed to attract additional capital to a variety of markets in support of public policy priorities are not new. These initiatives can take the form of capital matching, credit enhancements, guarantees, and tax incentives.

Outcomes-based financing is another tool available to governments. Service providers can gain access to investment capital based on a government commitment to pay if certain outcomes are achieved, and governments can test or expand services without taking on financial risk.

Adoption of these tools is recommended, in the context of a broader strategy for building the impact investment market, to ensure a clear vision and comprehensive plan for supporting the development of the supply, demand, and intermediation components of this market.

For example, support for business development, through accelerators or similar programs, is needed to develop a pipeline of investment-ready social enterprises and projects. Similarly, support for contract readiness represents an important complement to an outcomes payment fund, to build the capacity of service providers to engage in outcomes-based financing arrangements.

3. Establish an impact investing matching program, paired with appropriate incentives.

This could take the form of a fund, capitalized by the government, which would co-invest with private investors, either directly in eligible social enterprises or projects, or in impact investment funds that require additional capital to close a funding round.

A fund of funds would provide the scale necessary to attract large institutional investors (such as pension funds) to the market, and could be established through co-investments in partnership with these investors.

Regardless, incentives are recommended to attract new capital, for example, in the form of tax credits or first loss capital.

4. Establish an outcomes payment fund.

A dedicated fund for outcomes payments would catalyze the development of outcomes-based approaches to service delivery. The government could specify maximum prices that it is willing to pay per outcome, as has been done in the United Kingdom, enabling the market to respond with innovative solutions.

Outcomes-based financing can take a variety of forms, including payment-for-results contracts between governments and service providers and Social Impact Bonds (SIBs) – in which investors provide up-front financing for a particular service, generally delivered by one or more charitable or non-profit organizations, based on the commitment of an outcomes funder (often a government) to repay the principal and a risk-adjusted return if certain outcomes are achieved. The SIB is a relatively new model for funding social services. Lessons from other countries should inform the application of this model in Canada, as should the perspectives of service providers, investors, and governments, or other outcomes funders, on a case-by-case basis.

Supporting Recommendations:

- **Provide support for investment and contract readiness, to develop the pipeline of investment opportunities.**

- **Embed these initiatives in a broader strategy for building Canada's impact investment market, coordinating with other levels of government.**

- **Engage investors in the design of these initiatives.**

Conclusion

Impact investment – like venture capital for business start-ups – can provide much needed financing to test and implement innovative approaches to addressing a vast range of social challenges, and can provide an outcomes-focused lens that will help to demonstrate which approaches deliver the best results.

As a leader in Canada's impact investment market, the federal government could accelerate its growth, driving the development and implementation of initiatives designed to improve social and economic outcomes for individuals and communities.

Enabling impact investment and social entrepreneurship in the non-profit and charitable sector, and catalyzing impact investment through capital matching, investor incentives, and outcomes payments, are two immediate priorities for federal government action, and should be considered for inclusion in Budget 2015.

The MaRS Centre for Impact Investing and members of Canada's National Advisory Board are prepared to provide further advice and support to the federal government to help advance these recommendations, or related initiatives.

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