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Catalyzing the growth of the impact economy

A mature impact economy would help power economic growth while solving global social and environmental challenges. Here's what it will take to accelerate the impact economy's development.

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Since the term "impact investment" was introduced in 2007, the field of impact investing has grown and diversified in notable ways. Impact-fund managers have amassed record sums, continuing a trend that can be traced back at least five years. Funds have streamed money to impact investments from a variety of sources, and asset managers are making more investments outside the sectors that formerly attracted the lion's share of capital. Researchers have engineered novel ways of tracking and reporting impact, giving investors greater confidence that their money is producing social benefits and helping entrepreneurs make more effective decisions about their strategies and business models.

Amid these encouraging developments, it is possible to define a sharper vision for a healthy, mature impact economy that involves a wider range of actors and institutions than today's impact-investing industry. In an impact economy, the norms—practices, policies, and standards—that are attached to the pursuit of social impact would be as widely accepted, consistent, and stable as the norms that are associated with the pursuit of profit. Encouraged by the added measure of certainty and transparency surrounding their activities, investors large and small would allocate more capital to the financing of social initiatives, and entrepreneurs would devise business models whose ambition and growth potential match investor and market demand. Consumers would direct greater shares of their spending to social enterprises, thereby spurring large mainstream companies to measure and pursue impact. Overall, the impact economy would achieve breakthrough increases in scale and productivity, with capital delivering higher risk-adjusted levels of social impact than we now see in many cases.

In this article, which incorporates findings from our in-depth interviews with more than 100 investors, fund managers, social entrepreneurs, and other impact-economy stakeholders, we consider what it will take for the impact economy to reach maturity. We begin by exploring the vision for the impact economy outlined above. We then look at the roles that various impact-economy constituencies—investors, asset managers, entrepreneurs, governments, and philanthropists foremost among them—would play in a mature impact economy. Finally, we present three potential developments that would enable the impact economy to mature fully:

- instituting public policies that provide incentives and disincentives and create certainty
- achieving a broad commitment to mutually reinforcing operational, measurement, and reporting norms for fund managers, social entrepreneurs, and impact-economy intermediaries
- creating an industry body that promotes policies and standards of excellence and moves all participants to adopt them

These changes would enable and encourage stakeholders to reset some of capitalism's assumptions and rules so that two goals receive equal priority: powering economic growth and wealth creation while also solving global social and environmental challenges.

Envisioning a mature impact economy

Although some of the ideas and practices that are fundamental to impact investment and social entrepreneurship originated decades ago, it was in 2007 that a group of foundations and investors convened by the Rockefeller Foundation originated the term "impact investing," which was later defined as "investments intended to create positive impact beyond financial return."[1] (Others have proposed varying definitions of impact investment, although we do not seek to join that debate.[2]) Extending the idea at the heart of that definition—the creation of social or environmental impact in addition to financial return—to all other economic activities makes it possible to define an impact economy as a system in which institutions and individuals give equal priority to social impact and financial impact when making decisions about how to allocate resources.

An impact economy is thus a very different kind of system from a traditional capitalist economy that prioritizes only financial returns. In an impact economy, consumers and shareholders will challenge entrepreneurs and executives to show that they generate their profits in a manner that contributes to the public good. This approach to doing business is already being enacted by some organizations on several levels—in making strategic choices, in managing their supply chains, in allocating funds to investments—and by some municipal authorities. But we have yet to see it embraced comprehensively by entire industries or national economies. As such, we determined the major dimensions of a full-fledged impact economy to be investment deployment, asset management, delivery of solutions, and measurement and reporting.

Investment deployment

The past few years have seen capital flow into impact investments from a wide variety of sources (Exhibit 1). Overall, impact fund managers have amassed record quantities of assets under management: more than $228 billion, according to one estimate.[3] Yet even this amount of money is small compared with the annual capital outlay—estimated at $1.4 trillion to $2.5 trillion of additional spending—required to achieve the Sustainable Development Goals (SDGs) set forth by the United Nations by 2030. To close the gap, asset owners and fund managers will need to adopt investment strategies that put still more emphasis on positive social outcomes, rather than strategies that merely seek to minimize or prevent negative outcomes.

Investment trends appear to be moving in that direction. Based on surveys showing that a substantial number of investors, including "mainstream" investors, are seeking impact-investment products, there may be significant latent demand for impact investments. In a mature impact economy, then, we would expect to see more asset owners prioritizing the financing of solutions to environmental and social challenges, and a major increase in commitments of capital to impact-seeking investment vehicles.

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[1] Margot Brandenburg, Antony Bugg-Levine, Christina Leijonhufvud, Nick O'Donohoe, and Yasemin Saltuk, "Impact investments: An emerging asset class," JPMorgan Chase, the Rockefeller Foundation, and Global Impact Investing Network, November 29, 2010, jpmorganchase.com.

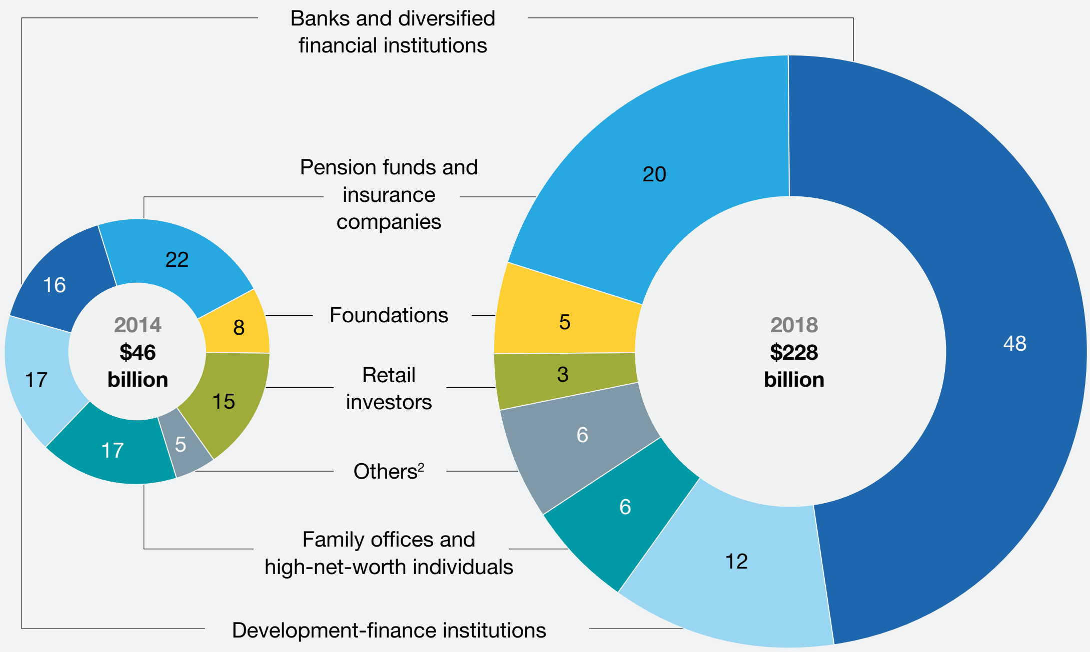
[2] For example, the Global Impact Investing Network defines impact investments as "investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return."

[3] Rachel Bass, Hannah Dithrich, and Abhilash Mudaliar, *Annual impact investor survey 2018*, Global Impact Investing Network, June 2018, thegiin.org.

Exhibit 1

Capital flows into impact investments from a variety of sources.

Impact investing assets under management by investment source,[1] % of total



[1]Assets under management reported as of beginning of year. Figures combine direct investments into companies, projects, or real assets and indirect investments made through intermediaries such as fund managers. Data are based on the Global Impact Investing Network's annual investor surveys and not intended to be exhaustive.
[2]Includes funds of funds, sovereign wealth funds, and others.

McKinsey&Company | **Source:** Global Impact Investing Network; McKinsey analysis

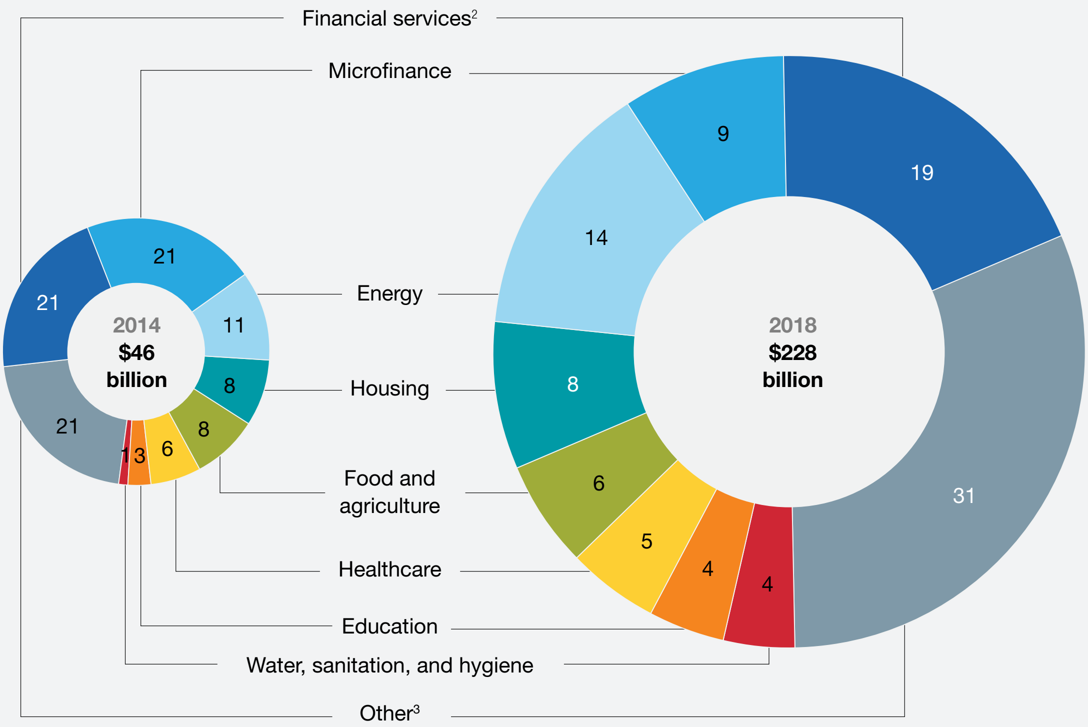
Asset management

Considering that the 17 SDGs address a wide range of issues—from human-development challenges such as poverty, health, and gender equality to environmental concerns such as climate change and water scarcity—asset managers in a mature impact economy might be expected to back enterprises with a correspondingly diverse variety of ambitions. The past few years have seen a trend in this direction, as asset managers have directed an increasing proportion of investments beyond the financial-services and microfinance sectors (Exhibit 2).

Exhibit 2

Impact investors are broadening into sectors beyond financial services and microfinance.

Impact investing assets under management by investment sector,[1] % of total



[1]Assets under management reported as of beginning of year. Data are based on the Global Impact Investing Network's annual investor surveys and not intended to be exhaustive.
[2]Other than microfinance.
[3]Includes arts and culture, conservation, information and communication technologies, manufacturing, and others.

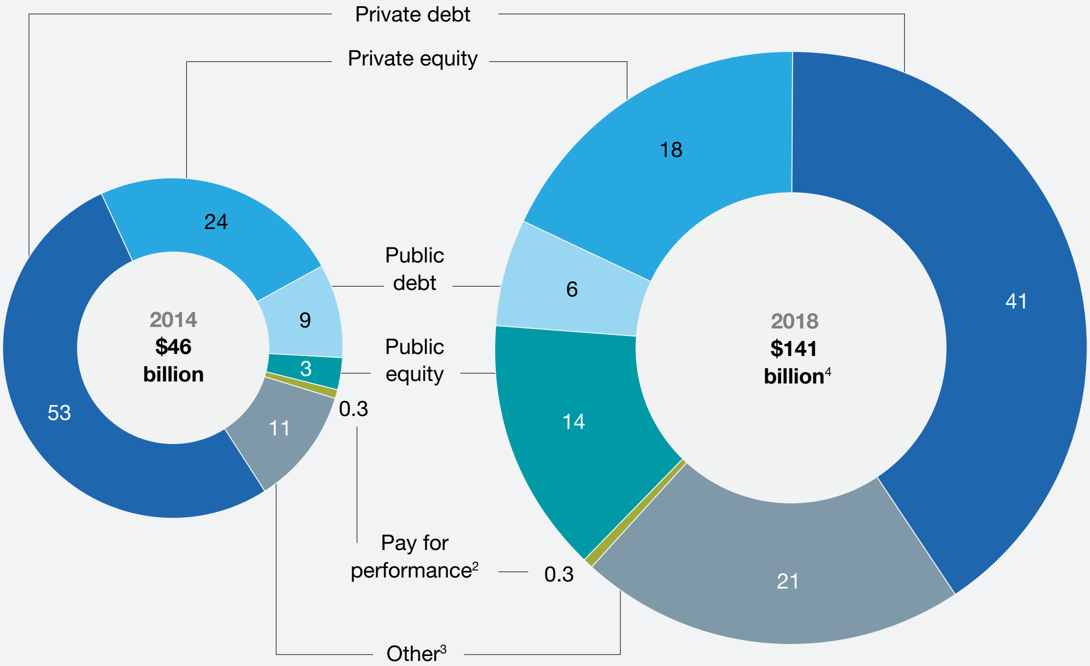
McKinsey&Company | **Source:** Global Impact Investing Network; McKinsey analysis

We would argue that a mature impact economy will also be characterized by a wide variety in the types of investment instruments that asset managers offer clients. Impact-investing assets under management are more evenly spread among different types of investment instruments than they were just three years ago, with private placements of debt and equity making up a considerably smaller share of the market (Exhibit 3).

Exhibit 3

While various investment instruments are in use, government pay-for-performance services remain underdeveloped.

Impact investing assets under management by type of instrument,[1] % of total



[1]Assets under management reported as of beginning of year. Data are based on the Global Impact Investing Network's annual investor surveys and not intended to be exhaustive. Figures may not sum, due to rounding.
[2]Outcome-based contracts, such as social impact bonds, that pay investors when enterprises achieve preagreed social outcomes.
[3]Including real assets, guarantees, and leases.
[4]The 2018 total given here differs from the 2018 total given in Exhibits 1 and 2 of this article because it excludes the particularly large pools of capital managed by two respondents to the Global Impact Investing Network survey.

McKinsey&Company | **Source:** Global Impact Investing Network; Social Finance; McKinsey analysis

Delivery of solutions

A mature impact economy would feature a market-clearing quantity of solutions to social and environmental challenges. In other words, impact enterprises would crop up to address environmental or social challenges that might be profitably addressed, although there will remain a large set of such challenges that cannot be solved with for-profit models. Moreover, these social enterprises would be no more likely to go unfunded than enterprises that measure their returns strictly in terms of profit (see sidebar, "A glimpse into the future of the impact economy"). This is not the situation today. Impact-focused enterprises have proliferated, and many of them operate on a modest scale, solving a particular problem in a single locale or a small number of locales. In the United Kingdom, for example, which has a relatively well-developed cohort of impact investors and social enterprises, more than 80 percent of social enterprises have annual revenues of less than £1 million.

In addition, the "buy side" of the "market" for social impact remains underdeveloped. Consumers are increasingly aware of the social and environmental impact of businesses, and more consumers have stated a preference for goods and services that help make a positive impact. This preference has become prevalent enough that companies can no longer afford to ignore it. Indeed, we are seeing large companies make greater efforts to align their market strategies with their customers' social compass, while new enterprises are emerging that have social impact built into their business models.

At the institutional level, though, there is only modest demand for what social enterprises can provide. Social enterprises are not yet widely recognized as potential bidders for public tenders or as partners for large companies, and government pay-for-performance schemes (outcome-based contracts such as social-impact bonds) have limited uptake. In a mature impact economy, where social enterprises will come to be seen as reliable producers of social goods, we might expect such pay-for-performance schemes to account for more of the impact-investing market.

A glimpse into the future of the impact economy

Even when social entrepreneurs can show potential investors that their companies have good prospects of achieving profitability, they sometimes have difficulty raising funds if they cannot offer a clear exit strategy. Adobe Capital, an impact-investment company focused on small Mexican companies with strong growth potential, developed a new financing structure for early-stage enterprises that have begun to generate revenue: a revenue-based mezzanine loan with flexible schedules and a repayment grace period.

Because the payments are revenue-based, the peso-denominated loan allows an enterprise to avoid large loan payments during periods when revenues are low. (Some loans have a minimum monthly payment; enterprises can reduce the principal they owe by paying more than the minimum.) The loan also includes an equity-conversion option at a predefined multiple. The convertible amount decreases as the principal is repaid, which allows the founder to retain more equity. And if the enterprise surpasses expectations and chooses to prepay the loan at the fixed multiple, the investment's internal rate of return (IRR) increases. An underperforming enterprise can still produce an IRR of 20 percent in US dollars.

Adobe Capital launched its $20 million Adobe Social Mezzanine Fund I (ASMF I) in 2012 to make investments in the form of these revenue-based mezzanine loans and other quasi-debt instruments. The fund invested in seven small and medium-size impact businesses in the healthcare, education, low-income-housing, and alternative-energy sectors. One of these businesses, NatGas, converts vehicles to engines that run on gasoline and natural gas and operates compressed-natural-gas filling stations. It also offers a financing program that helps its customers, mostly taxi and bus drivers with unstable incomes, to make smaller up-front investments. ASMF I made an 18 million peso investment in 2014. The company achieved profitability that year and saw its revenues grow through 2016. In 2017, ASMF I exited NatGas, realizing a 22 percent IRR and a 1.5 multiple of the original investment.[1]

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[1] Andrea Armeni and Miguel Ferreyra de Bone, *Innovations in financing structures for impact enterprises: Spotlight on Latin America*, Inter-American Development Bank, 2017, publications.iadb.org.

Measurement and reporting

A mature impact economy would operate according to generally accepted sets of standards for measuring and reporting social and environmental impact, which would help to quantify the value of social outcomes, support accurate tracking of progress toward the SDGs, and create the transparency that stakeholders need to make effective resource-allocation decisions. Such standards would represent the impact-economy equivalent of the Generally Accepted Accounting Principles to which US companies adhere, or the International Financial Reporting Standards used in many countries across the world. (It is worth noting that even for financial accounting and reporting, there are still multiple sets of standards in use.) Impact-economy standards would ideally supersede or harmonize existing frameworks, such as the Impact Reporting and Investment Standards (IRIS) and Social Return on Investment (SROI).

It is reasonable to expect that even in a mature impact economy some enterprises and investors will choose to define their impact goals in unique ways that don't conform to generally accepted standards and track their performance against those goals. Such idiosyncratic approaches, however, will likely become much less prevalent than they are today and occur only in contexts where generally accepted standards can't be applied easily.

Redefining the roles of impact-economy stakeholders

Transitioning to a mature impact economy will involve significant changes in the ways that its various constituencies, or stakeholders, conduct their business. Governments, for example, would pay for social outcomes that have been measured and verified, instead of paying service providers to do work that may or may not have the sought-after impact. Some stakeholders will find that a mature impact economy no longer requires them to perform the same functions that they performed when the impact economy was less developed, and so they will take on different roles (Exhibit 4).

Exhibit 4 **Each stakeholder's part will change as the impact economy matures.**

Stakeholders by level of maturity	**Seedling**	**Burgeoning**	**Mature**
Asset allocators	Major allocators adopt screening requirements	Allocators of all sizes apply "no negatives" requirements at minimum	Broad targeting and support of impact enterprises
Fund managers	Narrow range of investment products for institutional clients, targeting relatively few sectors	Wider array of investment products, including some retail offerings; broader sector coverage	Comprehensive array of institutional and retail products; sophisticated financing models
Social entrepreneurs	Small-scale enterprises with limited public profiles	Large- and small-scale enterprises with greater visibility	Numerous large social enterprises with strong reputations and experienced leaders
Governments	Desire to learn from other countries and to introduce pilot programs supporting the impact economy	Substantial reliance on pay-for-performance schemes; increased support of social enterprises	Policies that incentivize the continuous development of impact economy
Social-sector organizations	Small-scale efforts to seed and launch enterprises according to proven models	Greater investment in R&D to drive business innovation and talent acquisition	Consistent generation of ideas for large-scale enterprises; endowments are invested for impact
Intermediaries	Primary function is defining and explaining "rules of the road"	Major functions include convening stakeholders and promoting knowledge exchange	Independent rating agencies and professional-certification bodies create transparency and establish economy-wide norms
Consumers	Participation largely limited to communication and dialogue; some spending directed toward social enterprises	Closer alignment of stated preferences and spending patterns signals the narrowing of the attitude-behavior gap	Impact-oriented purchasing is a mainstream practice; active engagement with companies regarding key causes
Media and analysts	Intermittent coverage that treats impact enterprises as curiosities	Serious coverage of impact economy featured frequently in business press	High-profile coverage of impact economy, on par with coverage of traditional businesses

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Asset allocators, such as foundations and pension funds, would gradually progress from screening companies or sectors out of their portfolios depending on whether they fail to meet specific thresholds for social or environmental performance (a "no negatives" requirement) and toward actively targeting companies that intend to help solve social and environmental challenges (a "positive" or "positive offset" requirement).

Fund managers, responding to the needs and expectations of asset allocators, would devote less time and effort to seeding and nurturing early-stage impact models and more time to financing the expansion of organizations with large-scale impact potential. Some fund managers would also consider financing carve-outs and major transformations of organizations that can have a disproportionate impact on social or environmental opportunities. For fund managers, the ability to help impact enterprises scale up their activities to a significant degree would become an enduring source of what might be called "impact alpha"—social and environmental performance that consistently exceeds industry benchmarks.

Social entrepreneurs would undergo a radical change in composition: away from the private-sector stars whom many investors and fund managers now hope to attract into executive roles, and toward proven "public-sector champions." These are seasoned government officials and civil servants who have firsthand experience dealing with environmental and social problems that are rooted in market failures and therefore resistant to market-based solutions. As executives and managers at social enterprises, these public-sector champions not only commit to developing their own skills as leaders, they also assemble capable teams to pursue major opportunities for both revenue and impact, tapping into an expanding pool of millennials who are interested in impact-economy careers.

Governments would make a significant change to their operating model that sees them partner actively with private-sector organizations to deliver social outcomes. Amid rising costs (government spending is more than one-third of global GDP) and strained budgets (the global public-sector deficit is nearly $4 trillion a year), governments' longstanding approach to financing and implementing public services appears increasingly unsustainable. In a mature impact economy, governments would work with other stakeholders to produce social outcomes that governments lack the capacity to deliver and to boost the productivity of public spending on core services. This approach would require policy makers and civil servants to first adopt the mind-set that private-sector collaboration offers a means of increasing governments' effectiveness. Governments will also need the ingenuity to finance the delivery of social outcomes in a way that aligns the interests of private investors and enterprises with the interests of citizens. That will mean reassigning their most talented and creative people to engineer governments' collaborations with the private sector.

Just as importantly, governments would enact public policies that favor the continued development of the impact economy by providing incentives and reducing uncertainty for investors, entrepreneurs, and other stakeholders about the viability of the social sector. For example, the National Institution for Transforming India (also known as NITI Aayog), a think-tank-style branch of India's government, has mapped the activities of various government ministries against the SDGs and tracks the social outcomes they produce.

Social-sector organizations would pursue fewer innovations in cost containment and excellence in donor management, and more innovations in scaling and excellence in outcomes. This would represent a significant shift away from the risk-averse mode in which many social-sector organizations now operate, by which they adhere to such practices as keeping employees' salaries low to avoid criticism for excessive spending on administrative activities. Instead, social-sector organizations in an impact economy would increase their spending in research and development or use part of their long-term endowment to make impact investments. These approaches would embolden impact investors and social entrepreneurs to invest more in their own institutional capabilities and people.

Intermediaries would move beyond merely explaining how to use various impact measures and instead compile and publish impact ratings in a new role as independent rating agencies. This activity would create greater transparency across the impact economy and reinforce demand for consistent, reliable ratings among asset allocators, investors, impact organizations, and policy makers. Highly rated agencies would be rewarded for their work and interventions, such that they would receive more or lower-cost funds. Taking this activity further, intermediaries might develop and administer professional-certification programs for fund managers and other impact-economy participants, thereby acting as gatekeepers for the impact economy.

Consumers would shift out of their relatively passive roles, in which they have weak affiliations with organizations that support progress toward positive environmental and social outcomes, and adopt patterns of actively consuming goods and services from social enterprises and sustainable brands. This shift would represent the closure of the so-called attitude-behavior gap that separates consumers' stated preferences from their spending habits. Consumers would also help drive the development of an impact economy by engaging in local communities and political systems and expressing their views directly to institutions through traditional media, social media, and other channels.

Media organizations and analysts would take a more sophisticated approach to appraising and documenting the impact economy and its stakeholders. As the impact economy matures, media organizations would have less need to publish stories about the market distortions caused by traditional capitalism and could offer more stories about the positive outcomes produced by social enterprises and sustainability-focused enterprises. Top-tier media outlets would offer serious and high-profile coverage of the impact economy, as they do for the rest of the business world—think of an "Impact 500" business ranking that commands as much attention as annual rankings of the largest companies, wealthiest individuals, and fastest-growing businesses. Similarly, analysts in the financial and other sectors would reexamine their assumptions and make a renewed effort to evaluate impact-economy organizations on their merits and make their findings understandable to mainstream audiences. For their part, impact-economy stakeholders have an essential part to play in setting acceptable cultural and behavioral norms, demystifying concepts such as impact investment, and challenging the myths that surround these norms and concepts.

Redefining the impact economy's potential

Among the impact-economy stakeholders we have interviewed or spoken with, there seems to be general agreement on what a mature impact economy will look like. There is also a broad consensus on this point: the impact economy will not reach maturity until it develops policies, practices, and standards to govern the social dimension of impact-related economic activities.

Such norms are readily observed in mature sectors of the service economy such as accounting and finance. For example, when mainstream investors estimate their returns on potential deals and managers make choices for their businesses, they can compare the financial aspects of their options according to common accounting principles—norms that have taken the better part of a century to develop. But when investors and managers come to evaluating the impact-related aspects of their options, no such norms exist. And while impact investors are supposed to maintain professional certifications and abide by regulations in their roles as managers of other people's money, no such norms pertain to managing the social impact of their clients' investment holdings.

Certain other conditions, such as a limited flow of funding, also limit the growth of the impact economy, although targeted government interventions could correct these with relative ease. (For example, the UK government used funding from dormant bank accounts and four large UK banks to provide seed capital to new impact-investment managers.[4]) The lack of norms governing the social dimension of impact investing, then, arguably stands out as the most powerful constraint. As such norms are established, we anticipate that the transition to an impact economy will accelerate and flows of capital, talent, and knowledge will increase. Three activities can help establish the norms that stakeholders say they need to devote more of their time and resources to the impact economy.

Instituting public policies that provide incentives and disincentives and create certainty for stakeholders. Governments can consider instituting policies that would encourage impact investments and the expansion of social enterprises. One such policy is incentives—for example, tax deductions for social investments that are similar to tax deductions for charitable donations. The United Kingdom has had this kind of tax-relief scheme in place since 2014 and expanded it in 2017. Incentives would also help attract wider interest in impact investments and stimulate the emergence of investment products for retail investors.

Other policy options include those that level the playing field for social enterprises, such as regulations that permit nonprofit organizations to earn revenues from the provision of services. Policy makers can also consider additional ways of creating demand for enterprise-created social impact. New approaches to contracting for public services could let government entities act as "purchasers" of social outcomes that could be funded with social-impact bonds or other impact investments.

Achieving a broad commitment to mutually reinforcing operational, measurement, and reporting norms for fund managers, social entrepreneurs, and impact-economy intermediaries. As in other fields, professional requirements and standards for conduct would help increase the quality and consistency of services provided by fund managers, social entrepreneurs, and other impact-economy stakeholders, just as they do in other fields. Industry associations could help by defining the competencies that these professionals must possess and developing programs to test and accredit those who wish to do business in the field.

[4] "Launch of Big Society Capital—the world's first ever social investment market builder," Cabinet Office and Rt Hon David Cameron, April 4, 2012, gov.uk.

Widely accepted standards and norms are especially needed for measuring and reporting impact. It is not uncommon for impact-fund managers to track social impact with metrics taken from numerous sets of standards. In a survey of fund managers, only 24 percent of respondents said they use a set of standard metrics across all the investments in their portfolios.[5] The overwhelming majority select particular sets of metrics for each investment, sector, impact, or customer-specific objective. Social enterprises, too, have multiple sets of impact indicators to choose from. These disparate approaches to measurement impose administrative burdens: asset owners must figure out how to compare the effectiveness of fund managers that report impact in different ways, and fund managers and social entrepreneurs must spend time studying different sets of indicators and deciding how to apply them. A single set of indicators, covering the many sectors, themes, and contexts in which impact can be tracked, would alleviate this burden and help promote accountability and transparency. One recent idea of this kind, proposed by the Global Steering Group for Impact Investment, is that of "impact-weighted financial accounts," which use multipliers to estimate a company's social impact based on ordinary financial measures.

Creating an industry body that promotes policies and standards of excellence and moves all participants to adopt them. Some impact-economy constituents, particularly among asset managers and entrepreneurs, are relatively new to the tasks of financing and creating social impact. It is also apparent that these relative newcomers spend a lot of time developing the systems and processes to operate impact-economy organizations. (Investors have picked up on this; some have shared concerns that fund managers lack the skills required to deliver social returns on investment.) Foundations and investors have done a great deal to assist fund managers and entrepreneurs by setting up organizations where they can exchange knowledge and ideas. A well-organized industry body could now streamline the adoption of policies and standards by acting as a clearinghouse for this kind of knowledge.

■ ■ ■

Given the extent of the world's social and environmental challenges, a major increase in the scale and reach of the impact economy is urgently needed—and will be hard to achieve. Investors, entrepreneurs, governments, and other stakeholders will need to overcome their own practical constraints and prepare themselves to assume new roles. These individual efforts will be complicated by the dynamics of convincing multiple stakeholders to agree on the shifts that have to take place and compelling them to work together rather than pursue individual agendas. An essential first step will be to agree on a shared vision for the impact economy, along the general lines proposed in this paper. With such a vision in mind, impact-economy stakeholders can together start to carry out the three main tasks described above and register initial successes that will provide motivation for a continued, sustained effort. None of this will be easy, but as the impact economy matures, it will bring new rewards to stakeholders while enhancing the welfare of people worldwide.

[5] Rachel Bass, Hannah Dithrich, Abhilash Mudaliar, and Aliana Pineiro, *The state of impact measurement and management practice*, Global Impact Investing Network, December 2017, thegiin.org.

Further information about this publication

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