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Impact Investing to the Test of Pigou and Coase: for a Legal Approach to the Market

FINANCE & SUSTAINABILITY
S.R.L.

Abstract

Findings

The Theory of Externalities provides for an efficient approch to the undestanging of social impact market.

Social impact and sustainability are synonymous.

Law 208/15 on benefit corporation and European Regulation 2017/1601 are evidence of the link between Theory of Externalities and Social Impact.

Taxonomic approaches might be not usefull.

Conclusions

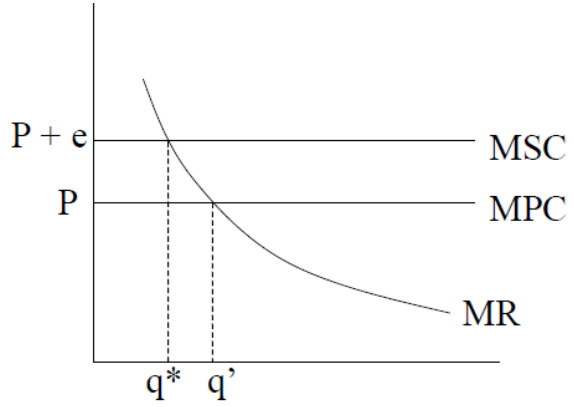
- In accordance to the Italian and European legislation, it is possible to create a systematic reconstruction of the social impact market based on the theory of externalities;
- In this prospective, sustainable economy and social impact investing describe the same economic phenomenon;
- The preferred areas of intervention of the sustainable economy currently refers to market failure and suboptimal market;
- On the basis of the proposed approach it is possible to create model of measuring of the impact based on “what if” scenarios;
- The intervention of the lawmakers shall be oriented on the identification of the cost bearer and of the legal remedies for the efficient allocation of the resources and, therefore, for the symmetric allocation of the externalities of the market.

Everybody Knows

Theory of Externalities

Marginal social cost= marginal private cost + marginal external cost.

MSC (marginal social cost) MPC (marginal private cost) MEC (marginal external cost)



… and what was the opinion of Ronald Coase

- *The reciprocal nature of externalities* and the consequence that, within certain circumstances, it is more efficient for the externalities' "victim" to change its behavior than for the author (the polluter).

- *Transaction costs, public good and holdout problems*. In the market, certain transaction costs (e.g. lawyers) are capable of making the exchange inefficient and pushing predatory responses by the operators who could decide not to take part to the transaction and try to get a "free ride".

- *The possibility to internalize the externalities.* Finally, Coase noted that an interested party (in the absence of legal remedy in term of property rules) had the chance to pay or to be indemnified in the event of the externalities' occurrence

The “classic” example: pollution

Pigou Approach

- a company producing bicycles at €175/piece cost and a pool of customers willing to buy bicycles at €200/piece price: every purchase within these two values (200 – 175 = €25) generates wealth
- If the cost of pollution is €30 this is a market failure

Coasan Approch

- If a polluting factory should pay €100 for a depurator while the near farmers should pay €50 to move their stables, an economically efficient choice shall request to sacrifice farmers’ interests (*Reciprocal nature*)
- some people could opt not to participate to the transaction or to ask for an higher price in order to prevent the company from emitting polluting substances, hence increasing costs upon the efficient ones (*Transaction costs, public good and holdout problems*)
- an amount between €50 and €100 paid by way of either compensation or indemnity would still optimize the market, in the absence of a legal ban on pollution (*internalization*)

Lawyer vs Economist: how many barber shops there are in El Cairo?

Economist

- On the assumpiont that El Cairo has 10 million inhabitants
- divide it by two (male and female: 5 million each)
- consider the frequency of a haircut (once a month)

and finally will reach a total demand of 60.000.000 haircuts per year.

Then, in order to calculate the side of offer,

- will consider an average duration of a haircut (15 minutes)
- the average opening hours of a barber shop (8 hours per day),

arising at a total of 32 haircuts per day and 9.600 per year (considering 300 day jobs a year).

Therefore, in order to satisfy a demand of 60.000.00 haircuts, **6.250** barbers will be needed.

Lawyer

- Call the chamber of commerce

All the markets have a regulation, at least principles

Article 3 Teatry of Lisbon

- *the Union] shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive **social** market economy, aiming at full employment and **social** progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance.*
- *It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child.*
- *[…]It shall contribute to […]sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights […].*

European Regulation 2017/1601

- *to support investments primarily in Africa and the Union's Neighbourhood as a means to contribute to the **achievement of the Sustainable Development Goals of the United Nations (UN) 2030 Agenda***
- *"The EFSD should maximise additionality, address **market failures** and **sub-optimal investment** situations*

Law 208/15

«a company which pursuing an economic activity, beyond the scope of share the relevant profits, pursues one or more than one scope of common benefit and which acts responsibly, in sustainable and transparent way with the people, communities, lands and environments, cultural assets and activities, entities and associations and other stakeholders". **Common Benefit**" is defined "*as the pursuit, in the exercise of an economic activity of the benefit corporation, of one or more than one positive effect or reduction of negative effects*

Possible Approach: A more Detailed Description of the Market

Sustainability is the capacity of a market in the long term to internalize externalities

Is there a catalogue of externalities? What is part of the demand and of the offer?

An answer from impact investing

Considering the impact investing market (according to the model of Global Impact Investing Network, 2014), this is formed by the following areas:

- *Access to finance: SME, microfinance and microcredit;*
- *Access to basic services: food, agriculture, education, culture, health and housing;*
- *Green Technology: power efficiency, green energy, waste management;*
- *Sustainable development of land and environment: land recovery and bio-housing;*
- *Sustainable consumer goods: organic food, fair price productions*

Is a Taxonomy Approach Useful or Even Possible

- TEG *"Currently, no classification system exists at EU-level and market-led initiatives of recent years are not comprehensive enough to sufficiently reflect all EU environmental and broader sustainability priorities"* in order to conclude "*The taxonomy will serve as a basis for the future establishment of standards and labels for sustainable financial products that provide sustainable capital flows"*
- (GIIN) e "*investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return*"
- (OECD) "*social impact investing provides finance to organizations addressing social and/or environmental needs with the explicit expectation of a measurable social, as well as financial, return*

Regulation

Maybe not organized, but existing

Intentionality

Why excluding

Measurability

Objective/Subjective

First conclusion

- social impact tends naturally to the internalization of externalities and to minimize cases traditionally considered as market failures, overcoming the main critics raised by the Coase theorem.
- Under a different light, social impact segments are more capable of fully “describing” the market formants (offer and demand), taking more efficiently into account costs and benefits associated to those.

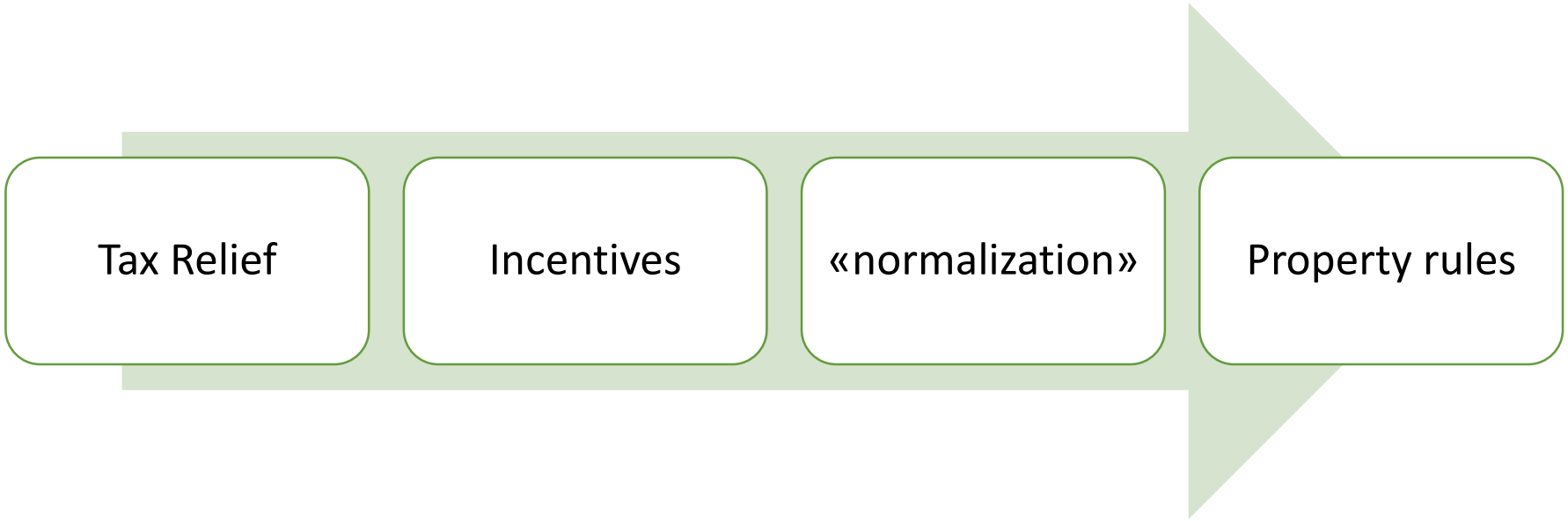
- Moreover, in the light of the European and national market principles, we can assess that social impact is a form of compliance (the only worth considering) with current legal obligations to create a sustainable market, that every market should become “social impact” and that every economic player should follow the rules of this kind of market.

- By this point of view, a taxonomic approach risks not to be feasible or useful if not directed to a pre-selection of what externalities have to be included or excluded as a social cost to the marginal cost of the offer (MSC=MPC+MEC).

Methodological Conclusions

- who should bear costs and enjoy benefits from externalities?

Model from the market of energy: a market of externalities?



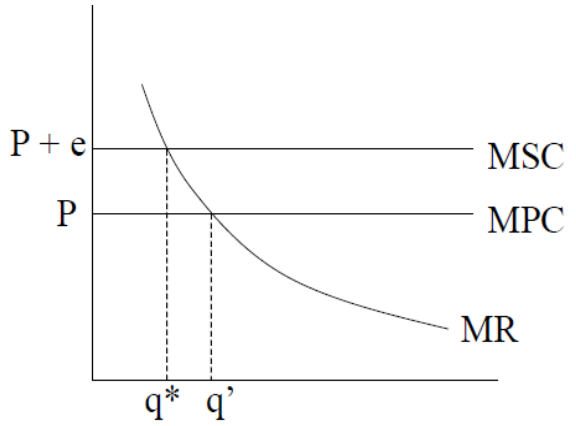
Methodological Conclusions
how do we calculate costs and benefits of internalizing an externality?

- Current methods

- **Expected Return**. These methods take into account the anticipated social benefits of an investment against its cost, discounted to the value of today's value. Examples are SROI (Social Return on Investment); Benefit Cost Ratio (BCR) and Economic Rate of Return (ERR).
- **Theory of Change**. Theory of Change and logic model explain the process of intended social impact. Specifically, logic model is a common tool used to map a theory of change of an organization, intervention or program by outlining the linkage from input, to activities, to output, to outcomes and ultimately to impact.
- **Mission Alignment**. These methods measure the execution of a strategy against mission and end goals over time; examples includes value criteria and scorecards.
- **Experimental Methods**. These methods are after-the-fact evaluations that use a randomized control trial or other counterfactual to determine the impact of the intervention compared to the status quo.

What if?

Calculate social costs and benefits on a pre-selection of externalities



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