November 2016 |Research # 109

Executive Summary

Tax Incentive For Social Investment

Shiran Vaknin-Froymovich
Research Supervisor:
Adv. Davida Lachman-Messer

Jerusalem Institute for Israel Studies
Milken Innovation Center

About the Milken Innovation Center Fellows Program

The Milken Innovation Center Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

The Program awards annual fellowships to outstanding Israeli graduate students. We train and deploy some of Israel's best and brightest young professionals to create pragmatic financing and economic policy solutions.. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own projects during their internship aimed at barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support business and policy makers to shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research training workshop where they work with senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course, taught at the Hebrew University School of Business Administration by Prof. Glenn Yago.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain.

The Fellows Program is a non-partisan. It is funded, in part, by the Milken Institute and other leading philanthropic organizations and individuals in the United States and Israel.

The intensity and range of social problems in the 21st century, together with increasingly limited budgetary resources, require governments worldwide to search for innovative and creative ways to finance solutions. This study was conducted in light of this challenge, and includes in-depth reviews of the actions of the United Kingdom and the United States in the field of tax incentives and special legislation for impact investments. Then, the study turns to the practical issue of encouraging impact investments and building social capital market in Israel, and offers a potential solution appropriate for Israel, in the form of a tax incentive.

The development of social capital market in Israel would be a quantum leap in terms of the country's ability to deal with social problems. Activity based solely on philanthropic donations is insufficient, and therefore social investments are necessary. Encouraging such investments by providing tax incentives is usually very successful, as seen in the experience of the United Kingdom in particular. The tax incentive not only will attract new capital for impact investment, but also will address the fundamental obstacles that hinder the development of social capital market in Israel.

"Impact investment" is defined as an investment which aims to achieve social or environmental return alongside economic/ financial return. Impact investments can increase and diversify an investment portfolio, and offer previously unavailable financing tools to social organizations, and through those tools help spur innovative ways of dealing with social problems. The purpose of social finance is to adopt the most innovative methods used in the financial world in order to make the best use of various capital sources - public, philanthropic and business – with the goal of adequately addressing the financing needs of social organizations and develop innovative ways of dealing with social problems.

The demand for impact investments consists of traditional financial market players, as well as new entrants to the sector: the traditional players are associations and companies in the public interest, and the new players are social businesses and Social Impact Bonds. The main sources for social investments are donations, debt investments, equity investments and social impact bonds.

Unlike England and the United States, Israel does not have tax incentives for any types of impact investments, except the tax incentives for philanthropic donations to nonprofit organizations.

The United Kingdom is the global leader in the development of the impact investment field. The UK has used a range of tools to develop innovative financial instruments and the development of dedicated funds and social investment. The British government has set special legislative arrangements and provided tax breaks in order to incentivize private sector and philanthropic investment in social enterprises and other projects with social returns.

In the United States, policy surrounding impact investments is marked by initiatives of the private sector and the public sector, and cooperation between sectors. The main method to facilitate impact investment in the United States is the leveraging of public and private funds through tax incentive programs in order to increase capital for social projects and programs. The US federal government has created special regulations and financial instruments to provide incentives for impact investors, though individual investors do not qualify for the programs directly.

Similar to start-up investments, impact investments are characterized by high risk and low yield compared to their risk profile, which means investors are often hesitant to invest in this type of product, despite the important prospect of a social return. Providing an impact investment tax incentive will increase the profitability of social investment for the investor, and consequently will help to increase the resources available for addressing social issues. The impact investment tax incentive reduces the cost of borrowing for social enterprises, and minimizes the competitive disadvantage resulting from the obligation to promote social goals at the expense of maximizing profits.

The proposed tax incentive to encourage social investments should be implemented by adding an amendment to the **Angels' Law (2011),** and would include tax incentive for all types of impact investors and for all types of impact investments. The tax incentive should be given for both equity and debt investments in social enterprises, in order to allow for an increase in the financial resources available to projects with a well-defined social return without discriminating between different types of investments.

The Angels' law has already provided an appropriate solution for encouraging a certain type of impact investment, and the use of an existing mechanism, which is recognized by the tax authority, will simplify the process of implementation and operation of the new tax credit tool. The tax incentive will be granted only to investors who have committed impact investment priorities, which must be recognized and regulated by the Israeli Corporations Authority and subject to government legislation that will be determined and published in advance. More, as has been done in England, there is a need for a limit on the maximum benefit amount an investor is allowed to claim as part of the social investment tax incentive. This limit would help the Israel Tax Authority to prepare in advance for the short and long run foregone revenue. In sum, there is a need for legislation dedicated to the issue impact investment tax incentives, as has been done in different ways in England and the United States, and a tax credit structured to provide that incentive is the most realistic and sustainable solution.

The Jerusalem Institute for Israel Studies
Milken Innovation Center
20 Radak St. Jerusalem 9218604
Office: 02-5630175 (Ext. 34)
www.jiis.org.il
www.milkeninnovationcenter.org